

STUDY TEXT



CA SRI LANKA CURRICULUM 2015

KB1

Business Financial Reporting

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# Contents

	Page
Introduction	v
Chapter features	vii
Learning outcomes	viii
Action verbs checklist	xv

## KB1 Business Financial Reporting

### Part A The framework of financial reporting

1	The Regulatory Framework	3
2	The Conceptual Framework	31
3	Non-financial Reporting	61
4	Presentation of Financial Statements	73

### Part B Financial reporting standards: recognition and measurement

5	Property, Plant and Equipment	109
6	Investment Property	133
7	Intangible Assets	151
8	Impairment	171
9	Leases	193
10	Other Standards Related to Assets	215
11	Provisions and Events after the Reporting Period	255
12	Revenue	281
13	Income Taxes	299
14	Financial Instruments	331
15	Employee Benefits	367
16	Share-based Payments	395

### Part C Financial reporting standards: disclosure

17	Assets Held for Sale and Discontinued Operations	417
18	Related Party Transactions	433
19	Operating Segments	447
20	Earnings Per Share	461

## **Part D Consolidated financial statements**

21	Principles of Consolidation	485
22	Consolidated Statement of Financial Position	507
23	Consolidated Statement of Profit or Loss	537
24	Associates and Joint Arrangements	565
25	Statements of Cash Flows	593

## **Part E Small company reporting**

26	Small Company Reporting	617
----	-------------------------	-----

## **Part F Financial statement analysis**

27	Financial Statement Analysis	631
----	------------------------------	-----

<b>Index</b>	<b>673</b>
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# Introduction

## KB1 Business Financial Reporting

At the Business Level a student is expected to apply the concepts in accounting to different types of organisations and have a sound knowledge of how the financial reporting standards impact the preparation and presentation of financial statements. The ability to analyse financial information and draw inferences relating to performance is also expected at this level.

## Syllabus structure

Main syllabus areas	Weightings
1. Conceptual and Regulatory Framework for Financial Statements	15%
2. Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)	50%
3. Preparation of Financial Statements	25%
4. Financial Statement Analysis and Non-financial Reporting	10%

One of the key elements in examination success is practice. It is important that not only you fully understand the topics by reading carefully the information contained in this Study Text, but it is also vital that you practise the techniques and apply the principles that you have learned.

In order to do this, you should:

- Work through all the examples provided within the chapters and review the solutions, ensuring that you understand them;
- Complete the progress test for each chapter.

In addition, you should use the Practice & Revision Kit. These questions will provide you with excellent examination practice when you are in the revision phase of your studies.

## Pillar structure

The Curriculum 2015 is structured around three pillars, namely, **Knowledge, Skills** and **Personal**.

The Pillars are subdivided into specific subject areas or sub pillars and content is delivered to meet the requirements of three progressively ascending levels of competency, namely, **Executive, Business** and **Corporate**.

The Business Level builds technical abilities whilst enhancing interpersonal and communication skills and problem resolution skills as required of a Senior Business Accountant.

The **Knowledge Pillar** focuses on imparting sound technical knowledge required of a competent CA, and comprises five sub pillars that focus on the following subject areas:

Sub pillar 1: Financial Accounting and Reporting (FA&R)

Sub pillar 2: Management Accounting and Finance (MA&F)

Sub pillar 3: Taxation and Law (T&L)

Sub pillar 4: Assurance and Ethics (A&E)

Sub pillar 5: Management and Contemporary Issues (M&C)

	FA&R Sub Pillar	MA&F Sub Pillar	T&L Sub Pillar	A&E Sub Pillar	M&C Sub Pillar
Corporate Level	KC1 Corporate Financial Reporting	KC2 Corporate Finance and Risk Management	KC3 Corporate Taxation	KC4 Corporate Governance, Assurance & Ethics	KC5 Corporate Strategy & Contemporary Issues
Business Level	KB1 Business Financial Reporting	KB2 Business Management Accounting	KB3 Business Taxation & Law	KB4 Business Assurance, Ethics & Audit	KB5 Business Value Creation
Executive Level	KE1 Financial Accounting & Reporting Fundamentals	KE2 Management Accounting Information	KE3 Fundamentals of Taxation & Law	KE4 Processes, Assurance & Ethics	KE5 Commercial Insight for Management

## Chapter features

Each chapter contains a number of helpful features to guide you through each topic.

**Topic list** This tells you what you will be studying in the chapter. The topic items form the numbered headings within the chapter.

**Chapter introduction** The introduction puts the chapter topic into perspective and explains why it is important, both within your studies and within your practical working life.

**Learning Outcomes** The learning outcomes issued for the module by CA Sri Lanka are listed at the beginning of the chapter, with reference to the chapter section within which coverage will be found.



**Key terms** These are definitions of important concepts that you really need to know and understand before the exam.



**Examples** These are illustrations of particular techniques or concepts with a worked solution or explanation provided immediately afterwards.



**Case study** Often based on real world scenarios and contemporary issues, these examples or illustrations are designed to enrich your understanding of a topic and add practical emphasis.



**Questions** These are questions that enable you to practise a technique or test your understanding. You will find the answer underneath the question.



**Formula to learn** These are the formula that you are required to learn for the exam.



**Section introduction** This summarises the key points to remember from each section.



**Chapter roundup** This provides a recap of the key areas covered in the chapter.



**Progress Test** Progress tests at the end of each chapter are designed to test your memory.

**Bold text** Throughout the Study Text you will see that some of the text is in bold type. This is to add emphasis and to help you to grasp the key elements within a sentence or paragraph.

## Learning outcomes

CA Sri Lanka's Learning outcomes for the Module are set out on the following pages. They are cross-referenced to the chapter in the Study Text where they are covered.

1. Conceptual and Regulatory Framework for Financial Statements (Syllabus Weighting: 15%)				
Knowledge Component	Knowledge Dimension	Knowledge Process	Learning Outcome	Chapter
1.1 Conceptual framework of SLFRS	Conceptual	Application	1.1.1 Demonstrate knowledge of the conceptual framework of Sri Lanka Accounting Standards, with emphasis on: <ul style="list-style-type: none"> <li>- Objectives of general purpose financial statements</li> <li>- Underlying assumptions</li> <li>- Qualitative characteristics of financial statements</li> <li>- Elements of financial statements</li> <li>- Recognition and measurement of elements of financial statements</li> <li>- Concepts of capital and capital maintenance</li> </ul>	2



Knowledge Component	Knowledge Dimension	Knowledge Process	Learning Outcome	Chapter
1.2 The process of setting standards	Conceptual	Application/ Analysis	<p>1.2.1 Outline the process of setting standards under Sri Lanka Accounting Standards (SLFRS and LKAS) and International Financial Reporting Standards (IFRS and IAS).</p> <p>1.2.2 Demonstrate the relationship between the International Accounting Standards Board (IASB) and the local governing body responsible for establishing national standards, with respect to the standard-setting process.</p>	1
1.3 Regulatory framework	Conceptual	Comprehension/ Analysis	<p>1.3.1 Demonstrate the awareness of provisions in Corporate governance, Companies Act (sections 56, 69, 148 to 171 and 192) and SEC regulations and rulings.</p> <p>1.3.2 Discuss the structure of the accountancy profession.</p> <p>1.3.3 Discuss the regulations applicable to the accounting profession and financial service industry.</p> <p>1.3.4 Discuss the disciplinary procedures relating to accountants.</p>	1

2. Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC) (Syllabus Weighting: 50%)				
Knowledge Component	Knowledge Dimension	Knowledge Process	Learning Outcome	Chapter
<p>2.1 Level A</p> <p>Thorough knowledge and comprehension of the standard to identify significant complicated issues and any potential implications to the financial statements, and to exercise professional judgment in the evaluation and application of standards in resolving a complicated matter related to financial reporting.</p> <p>Where:</p> <ul style="list-style-type: none"> <li>A “complicated matter” includes transactions and/or events which require thorough analysis of the matter and evaluation of standards.</li> <li>It may require the analysis, application and evaluation of relevant standard/s.</li> </ul>	Procedural	Evaluation/ Synthesis	<p>2.1.1 Advise on the application of Sri Lanka Accounting Standards in solving complicated matters.</p> <p>2.1.2 Recommend the appropriate accounting treatment to be used in complicated circumstances in conformity with Sri Lanka Accounting Standards.</p> <p>2.1.3 Evaluate the impact of application of different accounting treatments.</p> <p>2.1.4 Propose appropriate accounting policies to be selected in different circumstances.</p> <p>2.1.5 Evaluate the impact of use of different expert inputs to financial reporting.</p> <p>2.1.6 Advise on the appropriate application and selection of accounting/reporting options given under standards.</p> <p>2.1.7 Design the appropriate disclosures to be made in the financial statements.</p>	<p>4, 5, 10, 11, 12, 25</p> <p>4, 5, 10, 11, 12, 25</p> <p>4, 5, 10, 11, 12, 25</p> <p>4, 5, 10, 11, 12, 25</p> <p>4, 5, 10, 11, 12, 25</p> <p>4, 5, 10, 11, 12, 25</p>

Knowledge Component	Knowledge Dimension	Knowledge Process	Learning Outcome	Chapter
<p>2.2 Level B</p> <p>Good knowledge and comprehension of the standard to identify moderately complicated issues and any potential implications to the financial statements, and to exercise professional judgment in the analysis and application of standards in resolving a moderately complicated matter related to financial reporting.</p> <p>Where:</p> <p>A “moderately complicated matter” includes transactions and/or events which require an analysis of a matter and evaluation of such matter with the related standard/s.</p>	Conceptual/ Procedural	Application/ Analysis/ Evaluation	<p>2.2.1 Apply Sri Lanka Accounting Standards in solving moderately complicated matters.</p> <p>2.2.2 Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.</p> <p>2.2.3 Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.</p> <p>2.2.4 Demonstrate appropriate application and selection of accounting/reporting options given under standards.</p> <p>2.2.5 Outline the disclosures to be made in the financial statements.</p>	<p>2, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 17, 18, 20, 21, 22, 23, 24, 26</p> <p>2, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 17, 18, 20, 21, 22, 23, 24, 26</p> <p>2, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 17, 18, 20, 21, 22, 23, 24, 26</p> <p>2, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 17, 18, 20, 21, 22, 23, 24, 26</p> <p>2, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 17, 18, 20, 21, 22, 23, 24, 26</p>

Knowledge Component	Knowledge Dimension	Knowledge Process	Learning Outcome	Chapter
<p>2.3 Level C</p> <p>Conceptual knowledge and understanding of the standard to identify simple issues, to exercise reasonable professional judgment in the application of standards in resolving a simple (straightforward) matter related to financial reporting.</p> <p>Where:</p> <p>A “simple transaction or event” includes transactions or events which require direct and conceptual application of standards.</p>	Conceptual	Remember/ Comprehension/ Application	<p>2.3.1 Explain the concepts/principles of Sri Lanka Accounting Standards.</p> <p>2.3.2 Apply the concepts/principles of the standards to resolve a simple/straightforward matter.</p> <p>2.3.3 List the disclosures to be made in the financial statements.</p>	<p>14, 15, 16, 19</p> <p>14, 15, 16, 19</p> <p>14, 15, 16, 19</p>

3. Preparation of Financial Statements (Syllabus Weighting: 25%)				
Knowledge Component	Knowledge Dimension	Knowledge Process	Learning Outcome	Chapter
3.1 Consolidated financial statements	Conceptual/ Procedural	Application	3.1.1 Prepare consolidated financial statements (Consolidated Statement of Financial Position and Consolidated Statement of Comprehensive Income) involving one or two subsidiaries and an associate firm, in accordance with SLFRS/LKAS, with emphasis on: <ul style="list-style-type: none"> <li>- Elimination of inter-company transactions and balances</li> <li>- Fair valuation of purchase consideration and identifiable assets and liabilities of acquired subsidiary</li> <li>- Pre- and post-acquisition profits</li> <li>- Goodwill or gain on bargain purchase of simple acquisition of a subsidiary</li> <li>- Gain/loss on disposal of a subsidiary</li> <li>- Non-controlling interest</li> <li>- Equity accounting</li> </ul>	22, 23, 24
3.2 Entity financial statements	Conceptual/ Procedural	Application	3.2.1 Prepare single entity financial statements (Statement of Financial Position, Statement of Comprehensive Income, Statement of Changes in Equity and Statement of Cash Flows) in accordance with the prescribed structure and content as per relevant accounting standards.	4

4. Financial Statement Analysis and Non-financial Reporting (Syllabus Weighting: 10%)				
Knowledge Component	Knowledge Dimension	Knowledge Process	Learning Outcome	Chapter
4.1 Financial statement analysis	Conceptual/ Procedural	Comprehension/ Application/ Evaluate	<p>4.1.1 Demonstrate a thorough understanding of the different techniques available to analyse financial statements, including ratio analysis and common size financial statements.</p> <p>4.1.2 Interpret relevant financial ratios, including profitability ratios, liquidity ratios, efficiency ratios, and gearing and solvency ratios.</p> <p>4.1.3 Advise on the interpretation of an entity's financial statements for different stakeholders.</p> <p>4.1.4 Demonstrate a thorough knowledge of the limitations of financial statement analysis techniques.</p>	27
4.2 Non-financial reporting	Conceptual	Analysis	4.2.1 Outline the progress towards non-financial reporting standards, including sustainability reporting and integrated reporting.	3

## Action verbs checklist

Knowledge Process	Verb List	Verb Definitions
<b>Tier - 1 Remember</b> Recall important information	<b>Define</b>	Describe exactly the nature, scope or meaning
	<b>Draw</b>	Produce (a picture or diagram)
	<b>Identify</b>	Recognise, establish or select after consideration
	<b>List</b>	Write the connected items one below the other
	<b>Relate</b>	To establish logical or causal connections
	<b>State</b>	Express something definitely or clearly
<b>Tier - 2 Comprehension</b> Explain important information	<b>Calculate/ Compute</b>	Make a mathematical computation
	<b>Discuss</b>	Examine in detail by argument showing different aspects, for the purpose of arriving at a conclusion
	<b>Explain</b>	Make a clear description in detail revealing relevant facts
	<b>Interpret</b>	Present in understandable terms or to translate
	<b>Recognise</b>	To show validity or otherwise, using knowledge or contextual experience
	<b>Record</b>	Enter relevant entries in detail
	<b>Summarise</b>	Give a brief statement of the main points (in facts or figures)

Knowledge Process	Verb List	Verb Definitions
<b>Tier - 3 Application</b> Use knowledge in a setting other than the one in which it was learned/solve close-ended problems	<b>Apply</b>	Put to practical use
	<b>Assess</b>	Determine the value, nature, ability or quality
	<b>Demonstrate</b>	Prove, especially with examples
	<b>Graph</b>	Represent by means of a graph
	<b>Prepare</b>	Make ready for a particular purpose
	<b>Prioritise</b>	Arrange or do in order of importance
	<b>Reconcile</b>	Make consistent with another
	<b>Solve</b>	To find a solution through calculations and/or explanations
<b>Tier - 4 Analysis</b> Draw relations among ideas and to compare and contrast/solve open-ended problems	<b>Analyse</b>	Examine in detail in order to determine the solution or outcome
	<b>Compare</b>	Examine for the purpose of discovering similarities
	<b>Contrast</b>	Examine in order to show unlikeness or differences
	<b>Differentiate</b>	Constitute a difference that distinguishes something
	<b>Outline</b>	Make a summary of significant features



Knowledge Process	Verb List	Verb Definitions
<b>Tier - 5 Evaluate</b> Formation of judgments and decisions about the value of methods, ideas, people or products	<b>Advise</b>	Offer suggestions about the best course of action in a manner suited to the recipient
	<b>Convince</b>	To persuade others to believe something using evidence and/or argument
	<b>Criticise</b>	Form and express a judgment
	<b>Evaluate</b>	To determine the significance by careful appraisal
	<b>Recommend</b>	A suggestion or proposal as to the best course of action
	<b>Resolve</b>	Settle or find a solution to a problem or contentious matter
	<b>Validate</b>	Check or prove the accuracy
<b>Tier - 6 Synthesis</b> Solve unfamiliar problems by combining different aspects to form a unique or novel solution	<b>Compile</b>	Produce by assembling information collected from various sources
	<b>Design</b>	Devise the form or structure according to a plan
	<b>Develop</b>	To disclose, discover, perfect or unfold a plan or idea
	<b>Propose</b>	To form or declare a plan or intention for consideration or adoption



# Part A - The framework of financial reporting



# The Regulatory Framework

## INTRODUCTION

The financial reporting process for companies is highly regulated in order that financial statements are relevant, reliable and comparable.

Sources of regulation include legislation and stock market rules.

Knowledge Component			
<b>1</b>	<b>Conceptual and Regulatory Framework for Financial Statements</b>		
<b>1.2</b>	<b>The process of setting standards</b>	1.2.1	Outline the process of setting standards under Sri Lanka Accounting Standards (SLFRS and LKAS) and International Financial Reporting Standards (IFRS and IAS).
		1.2.2	Demonstrate the relationship between the International Accounting Standards Board (IASB) and the local governing body responsible for establishing national standards, with respect to the standard-setting process.
<b>1.3</b>	<b>Regulatory framework</b>	1.3.1	Demonstrate the awareness of provisions in Corporate governance, Companies Act (sections 56, 69, 148 to 171 and 192) and SEC regulations and rulings.
		1.3.2	Discuss the structure of the accountancy profession.
		1.3.3	Discuss the regulations applicable to the accounting profession and financial service industry.
		1.3.4	Discuss the disciplinary procedures relating to accountants.

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1 Introduction	
2 The regulatory framework	
3 Companies legislation	1.3.1
4 SEC Regulations	1.3.1
5 Corporate governance	1.3.1
6 Accounting standards	1.2.1, 1.2.2
7 The accountancy profession	1.3.2, 1.3.3, 1.3.4

**1 Introduction**

**Financial reporting is a way of recording, analysing and summarising financial data. Financial statements are used by a wide variety of interested parties.**

**1.1 What is financial reporting?**

Financial reporting has developed over a number of years, and continues to evolve. It is the process by which organisations record the financial effect of transactions throughout the year before summarising this and presenting it in accepted formats for use by external parties, in particular investors and lenders.

**1.2 Financial statements within annual reports**

Financial statements are found within a company's annual report; however they are by no means the only information contained within such a report. It is becoming more and more usual to find extensive narrative reports before the financial statements. These may include directors' reports, management commentary, reports on corporate governance (Section 5) and sustainability or integrated reports (Chapter 3).

### 1.3 Users of the financial statements and annual reports

The International Accounting Standards Board (IASB) states in the *Conceptual Framework for Financial Reporting*:

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

The following groups may be interested in financial statements.

- (a) **Managers of the company** are appointed by the company owners to supervise the day-to-day activities of the company. They need information about the financial situation of the company as it is currently and as it is expected to be in the future. This is to enable them to manage the business efficiently and to make effective decisions. They are particularly interested in detailed information such as the profitability of particular product lines or age of receivables. This level of information is not generally required by other users of financial statements and is not presented within them. To access this level of information together with forward looking information, management accounts are usually prepared for use by the managers of a company.
- (b) **Shareholders of the company**, ie the company owners, want to assess how well the management is performing. They want to know how profitable the company's operations are and so the potential for dividend payments as well as whether their investment is sound.
- (c) **Trade contacts** include suppliers who provide goods to the company on credit and customers who purchase the goods or services provided by the company. **Suppliers** want to know about the ability of the company to pay its debts; **customers** need to know that the company is a secure source of supply and is in no danger of having to close down.
- (d) **Providers of finance to the company** might include a bank that allows the company to operate an overdraft, or provides longer-term finance by granting a loan. The bank wants to ensure that the company is able to keep up interest payments, and eventually to repay the amounts advanced.
- (e) **The taxation authorities** want to know about business profits in order to assess the tax payable by the company, including sales taxes.
- (f) **Employees of the company** should have a right to information about the company's financial situation, because their future careers and the size of their wages and salaries depend on it.

- (g) **Financial analysts and advisers** need information for their clients or audience. For example, stockbrokers need information to advise investors. Credit agencies want information to advise potential suppliers of goods to the company. Journalists need information for their readers.
- (h) **Government and their agencies** are interested in the allocation of resources and therefore in the activities of business entities. They also require information in order to provide a basis for national statistics.
- (i) **The public.** Entities affect members of the public in a variety of ways. For example, they may make a substantial contribution to a local economy by providing employment and using local suppliers. Another important factor is the effect of an entity on the environment; for example, as regards pollution.

Accounting information is summarised in financial statements to satisfy the **information needs** of these different groups. Not all will be equally satisfied.

## 2 The regulatory framework



**The regulatory framework of financial reporting refers to the many sources of regulation, including accounting standards, company law and stock exchange rules.**

### 2.1 GAAP

GAAP is generally accepted accounting practice. It signifies all of the rules and principles that govern accounting. GAAP is different in every country, but in most it is a combination of:

- National companies legislation
- Local stock exchange requirements
- Accounting standards

GAAP is usually supplemented by other non-mandatory sources of guidance including the statutory requirements and accounting standards of other countries and long-standing practice.

### 2.2 Sri Lankan GAAP

In Sri Lanka, the mandatory sources of GAAP are the following.

- (a) Companies' legislation
- (b) SEC Regulations and rulings
- (c) Accounting standards as issued by the Institute of Chartered Accountants of Sri Lanka (CASL)

Each of these is dealt with in more detail in the following sections of the chapter.



### 3 Companies legislation



**Several sources of legislation are relevant to the preparation and presentation of financial statements in Sri Lanka.**

There are a number of sources of legislation relevant to companies in Sri Lanka, including:

- Companies Act No 07 of 2007
- Sri Lanka Accounting and Auditing Standards Act No 15 of 1995
- Finance Act No 38 of 1971
- Inland Revenue Act No 10 of 2002
- Employees' Provident Fund Act
- Securities and Exchange Commission Act

The first three of these are discussed in more detail below.

#### **3.1 Companies Act No 07 of 2007**

The application of Sri Lanka Accounting standards is mandatory for all companies enacted under the companies Act No. 7 of 2007. Therefore financial statements of limited liability companies should be prepared based on the provisions of the Sri Lanka Accounting standards. The Institute of Chartered Accountants of Sri Lanka (CASL) is the only accredited authority that formulates Accounting and Auditing Standards in Sri Lanka. Accounting standards are discussed in more detail in section 6.

#### **3.2 Sri Lanka Accounting and Auditing Standards Act No 15 of 1995**

This legislation empowers CASL to issue accounting and auditing standards. The Act requires “specified business entities” to prepare and present their financial statements in compliance with Sri Lanka Accounting Standards.

The Act also created:

- The Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) to monitor and enforce compliance with Sri Lanka Accounting standards in specified business entities (SBEs)
- Two separate committees – the Accounting Standards Committee and the Auditing Standards Committee – with the authority to oversee accounting and auditing standards respectively.

SLAASMB carries out periodic reviews of published financial statements and audits of SBEs and publishes highlights of its reviews in its annual report. It has gradually increased its capacity in line with the increase in the SBE audit market.

### 3.3 Finance Act No 38 of 1971

These regulations specify how financial statements of government organisations should be prepared and presented. Finance professionals and accountants working in the government organisations need to follow the above regulations in their day to day work and in preparing financial statements.

## 4 SEC Regulations



**SEC Rules govern the listing of securities on the Exchange and continuing listing requirements in order to ensure the creation and maintenance of a market in which securities can be issued and traded in an orderly and fair manner and which secures efficiency and confidence of all stakeholders in the operation and conduct of the market.**

It is the duty of the board of directors of an entity to ensure that all the listing requirements are met on a continuing basis so long as its securities remain listed on the Exchange. It is the duty of the board of directors of a managing company of a fund to ensure that all the listing requirements are met on a continuing basis so long as units of such fund are listed on the Exchange.

The SEC Rules are summarised below:

<b>Initial listing (section 01)</b>	An applicant for a listing of Securities must comply with these Rules. An applicant is required to forward to the Exchange a listing undertaking. This shall constitute a binding contract between the applicant and the Exchange. An applicant Entity should in the first instance, list its shares, prior to applying for a listing of Other Class of Shares.
<b>Listing of shares (section 02)</b>	Shares may be listed on the Exchange provided that the listing is for all shares issued and to be issued by the entity. In the event of an offer for subscription or an offer for sale, shares shall be issued for cash only. In the event shares are to be listed by way of an introduction, such shares should have been allotted at least six months prior to the date of application to the Exchange, unless such shares have been offered in terms of a prospectus, as required by the Companies Act.

<b>Listing of debentures (section 02)</b>	<p>For debt securities to be eligible to be listed on the Exchange they shall be: (i) fully paid; (ii) freely transferable; and (iii) issued only for cash (in the event of offer for subscription or offer for sale). In the event a debt security is to be listed by way of an introduction, such debt security should have been allotted at least six months prior to the listing application, unless such debt security has been offered in terms of a prospectus as required by the Companies Act.</p>
<b>Content of prospectus/ introductory documents (section 03)</b>	<p>The Rules set out the basic requirements for the contents of a prospectus, which should be complied with in addition to the requirements of the Companies Act and any other applicable law. Additional information that is not required by the Rules may be included at the discretion of the entity according to the particular nature of the business of the issuer and of the securities for which listing is sought. The Exchange reserves the absolute right to require disclosure of any additional information as it considers appropriate in any particular case. If the Exchange requires such information, it shall inform the applicant in writing of the additional information required.</p>
<b>Further issue of securities of a listed entity (section 05)</b>	<ul style="list-style-type: none"> <li>• Where shares of a particular class have been listed on the Exchange, further shares of that class may not be issued by a listed entity until the issue and listing of such shares is approved by the Exchange.</li> <li>• Listing for a class of shares not already listed on the Exchange shall be in terms of this section.</li> <li>• Where the application is for another class of shares, the total value of all the other classes of shares issued at any given time (as set out in the latest balance sheet of the entity), whether listed or unlisted (including the other class of shares for which the application is made), shall not exceed 15% of the entity's shareholders' funds (stated capital plus reserves).</li> <li>• In the event of a rights issue or issue of shares through public subscription, shares shall be issued for cash only.</li> <li>• The Exchange retains the discretion to accept or reject applications for additional listings and to determine the requirements to be fulfilled in connection with such listings. The requirements set out in this Section are not exhaustive. The Exchange reserves the right to impose</li> </ul>

	further requirements as it may think relevant in the particular circumstances in which the additional listing is sought.
<b>Articles of Association or other corresponding documents (section 06)</b>	<p>The Articles of Association or other corresponding documents shall contain the following provisions:</p> <p>1. TRANSFER AND REGISTRATION OF SHARES:</p> <p>Notwithstanding any provision in these Articles suggesting the contrary, shares listed on the Colombo Stock Exchange shall be freely transferable and registration of the transfer of such listed shares shall not be subject to any restriction, save and except to the extent required for compliance with statutory requirements.</p> <p>2. NOTICES:</p> <p>a. Where notice is given by an advertisement, such advertisement shall be published in Sinhala, Tamil and English national daily newspapers.</p> <p>b. Any member whose registered address is not within Sri Lanka may name an address within Sri Lanka which, for the purpose of notice, shall be considered as his registered address.</p> <p>3. JOINT SHAREHOLDING:</p> <p>The Company shall not register more than three persons as joint holders (including the principal holder) of any shares (except in the case of executors, administrators or heirs of a deceased member).</p> <p>4. COMPLIANCE WITH RULES:</p> <p>Notwithstanding anything to the contrary contained in the Articles of Association of the company, so long as the company is listed on the Colombo Stock Exchange, the company shall comply with the Rules of the Colombo Stock Exchange and the Central Depository System, which shall be in force from time to time.</p>

<b>Trust deed (section 6)</b>	<p>The trust deed pertaining to a fund, the units of which are listed or sought to be listed on the Exchange, shall contain the following provision:</p> <p>TRANSFER AND REGISTRATION OF UNITS:</p> <p>Notwithstanding any provision in this trust deed suggesting the contrary, units of a fund listed on the Colombo Stock Exchange shall be freely transferable and registration of the transfer of such units shall not be subject to any restriction, save and except to the extent required for compliance with statutory requirements.</p>
<b>Continuing listing requirements (section 07)</b>	<p>All entities whose securities are listed on the Exchange shall comply with these Rules and such additional Rules as may be introduced from time to time at the discretion of the Exchange. All Entities whose securities are listed on the Exchange, whether or not such listing has taken place prior to these Rules shall, where applicable, be bound by these Rules and such additions, variations etc. made from time to time. It is the duty of the board of directors of every entity whose securities are listed to ensure that all the Rules of the Exchange are met on a continuing basis so long as the securities of such entity remain on the Exchange.</p>
<b>Corporate disclosure (section 08)</b>	<p>A listed entity shall make immediate disclosure of price sensitive information to the Exchange in order to ensure the maintenance of a fair and orderly securities market. 'Price sensitive information' in relation to any listed securities of an entity, is a reference to information which:</p> <ul style="list-style-type: none"> <li>(i) relates to specific matters relating to, or of concern (directly or indirectly) to, the entity; and</li> <li>(ii) is not generally known to those persons who are accustomed or would be likely to deal in those listed securities but which would, if it were generally known to them, be likely to affect materially the price of the listed security.</li> </ul>

<b>Related party transactions (section 09)</b>	<p>The objective of these Rules pertaining to related party transactions is to ensure that the interests of shareholders as a whole are taken into account by a listed entity when entering into related party transactions. The Rules set out in this section further provide certain measures to prevent directors, Chief Executive Officers or substantial shareholders taking advantage of their positions. The Rules contained in this section do not apply to a listed entity which proposes to enter into a transaction with a related party, where the shares of such listed entity have not been listed on the Exchange. A listed entity shall comply with these Rules pertaining to related party transactions with effect from 1 January 2016. Compliance with these Rules is voluntary for a period of two years with effect from 1 January 2014.</p>
<b>Enforcement (section 10)</b>	<p><b>NON-COMPLIANCE WITH LISTING RULES</b></p> <p>In the event of any violation and/or non-compliance with any of the Rules of the Exchange by any entity whose securities are listed on the Exchange, the Exchange shall transfer the securities of such entity to the “Default Board” and may publicly reprimand such entity and/or suspend trading of securities of such entity for any period of time and/or delist the entity from the Exchange. If an Entity fails to pay interest on debt securities listed on the Exchange on the ‘due date’, the securities shall be transferred to the “Default Board”.</p> <p><b>TRANSFER TO THE DEFAULT BOARD</b></p> <p>Prior to transferring the securities of the entity to the Default Board the Exchange shall inform the entity, in writing, of the default and that the securities of the entity would be transferred to the Default Board. The Securities shall be transferred out of the Default Board upon the entity complying with the relevant listing rules. In the event the security continues to be on the Default Board for a period in excess of one month the Exchange, in consultation with the SEC, shall have the right to issue a press notice informing the public of the nature of the violation. If the securities continue to be on the Default Board for a period in excess of three months from the date of transferring the securities of the entity to the Default Board, the Exchange, at its discretion, may refer the matter to the SEC for necessary action.</p>

**Fees (section 11)**

The fees set out in this section do not include the Value Added Tax (VAT) or any other taxes that are imposed by the relevant authorities.

## 5 Corporate governance



**Corporate governance is the system by which companies and other entities are directed and controlled.**

### 5.1 What is corporate governance?

**Corporate governance** is the system by which companies and other entities are directed and controlled.

The trigger for developments in corporate governance was the **collapse** of major international companies during the 1980s. These collapses were often unexpected, and dubious (or even fraudulent) activities were sometimes attributed to their owners and managers. These events represented a nasty shock for countries, such as the UK and the US, which felt they had well-regulated markets and strong company legislation. It became obvious, however, that part of the problem was the way in which regulation was spread between **different national authorities** for these global conglomerates, so that no one national authority had the whole picture of the affairs of such companies, nor full powers over the whole of the business.

Individual countries began to develop **better guidelines** for corporate governance, and efforts have been made to produce an international standard on corporate governance.

### 5.2 Corporate governance in Sri Lanka

CASL published a *Code of Best Practice on matters related to financial aspects of Corporate Governance* in 1997. The fourth edition of the publication *Code of Best Practice on Corporate Governance* was issued jointly by the institute of Chartered Accountants of Sri Lanka and the Securities and Exchange Commission of Sri Lanka, and is currently applied in Sri Lanka.

The Code contains the following guidance for directors:

<b>The board</b>	<ul style="list-style-type: none"> <li>• Every public company should be headed by an effective Board, which should direct, lead and control the company.</li> <li>• Board meetings should be held at least once in every quarter of a financial year.</li> <li>• It is preferable for the Board to have a balance of Executive and Non-Executive Directors such that no individual or small group of individuals can dominate the Board's decision-taking.</li> <li>• The Board should include Non-Executive Directors of sufficient calibre and number for their views to carry significant weight in the Board's decisions.</li> <li>• The Board should include at least two Non-Executive Directors or such number of Non-Executive Directors equivalent to one third of total number of Directors, whichever is higher.</li> <li>• In the event the Chairman and CEO is the same person, Non-Executive Directors should comprise a majority of the Board.</li> <li>• The total number of Directors is to be calculated based on the number as at the conclusion of the immediately preceding Annual General Meeting. Further, any change occurring to this ratio should be rectified within 90 days from the date of the change.</li> <li>• Where the constitution of the Board of Directors includes only two Non-Executive Directors, both such Non-Executive Directors should be 'independent'. In all other instances, two or one third of Non-Executive Directors appointed to the Board of Directors (whichever is higher) should be 'independent'.</li> </ul>
<b>Appointments to the board</b>	There should be a formal and transparent procedure for the appointment of new Directors to the Board.
<b>Re-election</b>	All Directors should be required to submit themselves for re-election at regular intervals and at least once in every three years.
<b>Appraisal of board performance</b>	Boards should periodically appraise their own performance in order to ensure that Board responsibilities are satisfactorily discharged.



<b>Disclosure of information in respect of directors</b>	Shareholders should be kept advised of relevant details in respect of Directors.
<b>Appraisal of chief executive officer (ceo)</b>	The Board should be required, at least annually, to assess the performance of the CEO.
<b>Remuneration procedure</b>	Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual Directors. No Director should be involved in deciding his/her own remuneration.
<b>The level and make-up of remuneration</b>	Levels of remuneration of both Executive and Non-Executive Directors should be sufficient to attract and retain the Directors needed to run the Company successfully. A proportion of Executive Directors' remuneration should be structured to link rewards to corporate and individual performance.
<b>Disclosure of remuneration</b>	The Company's Annual Report should contain a Statement of Remuneration Policy and details of remuneration of the Board as a whole.
<b>Communication with shareholders</b>	The Board should implement effective communication with shareholders.
<b>Major and material transactions</b>	Further to complying with the requirements under the Companies Act, Securities and Exchange Commission law and Colombo Stock Exchange regulations, as applicable, Directors should disclose to shareholders all proposed material transactions which, if entered into, would materially alter/vary the Company's net assets base or, in the case of a Company with subsidiaries, the consolidated group net asset base.
<b>Financial reporting</b>	The Board should present a balanced and understandable assessment of the Company's financial position, performance and prospects.

<b>Internal control</b>	The Board should have a process of risk management and a sound system of internal control to safeguard shareholders' investments and the Company's assets. Broadly, risk management and internal control is a process, affected by a Company's Board of Directors and management, designed to provide reasonable assurance regarding the achievement of Company's objectives.
<b>Audit committee</b>	The Board should establish formal and transparent arrangements for considering how they should select and apply accounting policies, financial reporting and internal control principles and maintaining an appropriate relationship with the Company's Auditors.
<b>Disclosures</b>	The names of Directors (persons in the parent company's committee in the case of a group company) comprising the Audit Committee should be disclosed in the Annual Report.
<b>Code of business conduct and ethics</b>	Companies must adopt a Code of Business Conduct and Ethics for Directors, and key management personnel, and must promptly disclose any waivers of the Code for Directors or others.
<b>Corporate governance disclosures</b>	Directors should be required to disclose the extent to which the Company adheres to established principles and practices of good corporate governance.

## 6 Accounting standards



**The IASB develops and publishes new International Financial Reporting Standards (IFRSs) according to its six-step due process. CASL can input to this process and, subsequent to issue, adopts IFRSs as SLFRS.**

### 6.1 Professional bodies

Professional accountancy bodies are found at a national and global level. The Institute of Chartered Accountants of Sri Lanka (CASL) is the body responsible for issuing accounting standards in Sri Lanka; its global counterpart is the International Accounting Standards Board (IASB), part of the International Financial Reporting Standards Foundation (IFRS Foundation).

### 6.1.1 The IFRS Foundation

The IFRS Foundation is the global body responsible for financial reporting. Its objectives are:

- (a) To develop, in the public interest, a single set of high-quality, understandable, enforceable and globally accepted financial reporting standards based on clearly articulated principles. These standards should require high-quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information make economic decisions.
- (b) To promote the use and rigorous application of those standards.
- (c) In fulfilling the above objectives, to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings.
- (d) To promote and facilitate adoption of IFRSs, being the standards and interpretations issued by the IASB, through the convergence of national accounting standards and IFRSs.

In order to achieve these aims, the IFRS Foundation operates through a number of bodies, each with specific responsibilities:

- (a) The International Accounting Standards Board (IASB) is responsible for the development of new IFRS (see Section 6.2).
- (b) The IFRS Interpretations Committee is a sub-body of the IASB and is responsible for the development of new Interpretations (see Section 6.3).
- (c) The IFRS Advisory Council provides a forum for the IASB to consult interested parties affected by their work. In effect, it acts as an information conduit between users of financial statements and the IASB.

### 6.1.2 The interaction of professional bodies

In 2009, the Institute of Chartered Accountants of Sri Lanka (CASL) made a decision to converge fully with all pronouncements issued by the IASB (subject to some minor modifications) and thereafter to adopt all pronouncements issued by the IASB.

CASL, along with other national standard setters, also has the opportunity to become involved in the development of new IFRSs through the IASB's due process for working on new pronouncements (see Section 6.2.3).

## 6.2 Accounting standards

The IASB issues International Financial Reporting Standards (IFRSs); prior to this, it issued International Accounting Standards (IAS). These are adopted by CASL as SLFRS and LKAS. The following table lists standards that are examinable at KB1.

	Title
LKAS 1	Presentation of financial statements
LKAS 2	Inventories
LKAS 7	Statement of cash flows
LKAS 8	Accounting policies, changes in accounting estimates and errors
LKAS 10	Events after the reporting period
LKAS 11	Construction contracts
LKAS 12	Income taxes
LKAS 16	Property, plant and equipment
LKAS 17	Leases
LKAS 18	Revenue
LKAS 19	Employee benefits
LKAS 20	Accounting for government grants and disclosure of government assistance
LKAS 21	The effects of changes in foreign exchange rates
LKAS 23	Borrowing costs
LKAS 24	Related party disclosures
LKAS 27	Separate financial statements
LKAS 28	Investments in associates and joint ventures
LKAS 32	Financial instruments: presentation
LKAS 33	Earnings per share
LKAS 34	Interim financial reporting
LKAS 36	Impairment of assets
LKAS 37	Provisions, contingent liabilities and contingent assets
LKAS 38	Intangible assets
LKAS 39	Financial instruments: recognition and measurement

	Title
LKAS 40	Investment property
LKAS 41	Agriculture
SLFRS 2	Share-based payment
SLFRS 3	Business combinations
SLFRS 5	Non-current assets held for sale and discontinued operations
SLFRS 7	Financial instruments: disclosures
SLFRS 8	Operating segments
SLFRS 10	Consolidated financial statements
SLFRS 11	Joint arrangements
SLFRS 12	Disclosure of interests in other entities
SLFRS 13	Fair value measurement
SLFRS	For small and medium-sized entities

### 6.2.1 Status of standards

IFRSs are not part of international law and therefore their use is not mandatory in a general sense. Their use in particular countries depends on their adoption by local authorities.

In Sri Lanka, the Sri Lanka Accounting and Auditing Standards Act No 15 of 1995 requires all companies to comply with accounting standards established by CASL:

- (a) All domestic companies whose debt or equity securities trade in a public market in Sri Lanka must use SLFRSs. This applies to both consolidated and separate financial statements.
- (b) All Specified Business Enterprises (SBEs) must apply SLFRSs, even where they are not listed. Specified Business Enterprises include:
  - Companies listed on a stock exchange
  - Banks
  - Insurance companies
  - Factoring companies
  - Finance companies
  - Leasing companies
  - Unit trusts
  - Fund management companies
  - Stockbrokers and stock dealers

- Stock exchanges
  - Public corporations engaged in the sale of goods or provision of services
- (c) Other companies may adopt either SLFRSs or the SLFRS for small and medium-sized entities (SMEs).

### 6.2.2 Due process for the development of IFRSs

IFRSs are developed through an international consultation process that involves interested individuals and organisations from around the world.

Due process comprises six stages:

- (1) Setting the agenda
- (2) Planning the project
- (3) Developing and publishing the discussion paper
- (4) Developing and publishing the exposure draft
- (5) Developing and publishing the standard
- (6) After the standard is issued

These stages are discussed in more detail below.

#### (1) Setting the agenda

The IASB is made aware of topics that may be added to its agenda through a number of channels: IASB staff themselves may raise issues, requests may be received from constituents or issues may arise from a change to an existing publication.

The Board then evaluates the merits of adding a topic to its work agenda mainly by reference to the needs of investors. In particular, it considers:

- The relevance and reliability of information that could be provided
- The availability of existing guidance
- The possibility of increasing convergence
- The quality of the standard to be developed
- Constraints on available resources.

Decisions to adopt new projects take place at public IASB meetings.

#### (2) Planning the project

When planning a project, the IASB will decide whether to conduct the project alone, or jointly with another standard-setter. The remainder of due process is unaffected by this decision.

A working group is established and a project plan drawn up.

**(3) Developing and publishing the discussion paper**

A discussion paper is not mandatory, however where a major new topic is being addressed, such a paper will introduce and explain the issue and solicit early comment from constituents. A discussion paper normally includes:

- A comprehensive overview of the issue
- Possible approaches to addressing the issue
- Preliminary views of the authors or IASB
- An invitation to comment

**(4) Developing and publishing the exposure draft**

An exposure draft (ED) is a mandatory step in due process. An ED is, in effect, a draft IFRS (or draft amendments to an existing IFRS).

In developing an ED, the IASB will consider comments received on any discussion paper and suggestions made by the IFRS Advisory Council, working groups and accounting standard-setters.

When an ED is complete, the IASB must ballot on it (to record whether they assent to or dissent from the draft) and it is then published for public comment.

**(5) Developing and publishing the standard**

The IASB will consider comments received on the exposure draft and, where necessary, may re-expose the topic (publish a second exposure draft).

When the IASB is satisfied that it has reached a conclusion on the issues arising from the exposure draft, the IFRS is drafted.

Finally, after due process is completed, all outstanding issues are resolved and the IASB members have balloted in favour of publication, the IFRS is issued.

**(6) After the standard is issued**

After an IFRS is issued, regular meetings are held between the IASB and interested parties (including other standard-setting bodies) to help understand unanticipated issues related to the practical implementation and potential impact of the standard. After a suitable time, the IASB may conduct a post-implementation review of a standard.

**6.2.3 Due process for the adoption of IFRSs as SLFRSs**

CASL exposes for public comment all IASB exposure drafts and draft interpretations. CA Sri Lanka also conducts chief financial officers' (CFOs') round

table discussions to identify the impact of the proposed standard in Sri Lanka. Afterwards, CA Sri Lanka forwards its views to the IASB.

When the IASB issues a final IFRS or Interpretation, CA Sri Lanka reviews the IFRS and related technical materials. In a few cases, this review has resulted in modification or deferral of the standard for use in Sri Lanka.

Thereafter, the standard is translated into Sinhala and Tamil and published in the *Extra Ordinary Gazette* as required by the Accounting and Auditing Standards Act No 15 of 1995 in Sri Lanka. Once gazetted, the standard becomes legally authoritative.

### 6.3 Interpretations

Interpretations, referred to as IFRICs (or previously SICs), are issued by the IFRS Interpretations Committee as necessary to:

- Interpret the application of IFRSs
- Provide timely guidance on financial reporting issued not specifically addressed in IFRSs

They are therefore of limited scope in nature, dealing with specific issues only. The Interpretations that are examinable at KB 1 are listed below.

	Title
IFRIC 1	Changes in existing decommissioning, restoration and similar liabilities
IFRIC 4	Determining whether an arrangement contains a lease
IFRIC 5	Rights to interests arising from decommissioning, restoration and environmental rehabilitation funds
IFRIC 6	Liabilities arising from participating in a specific market – waste electrical and electronic equipment
IFRIC 10	Interim reporting and impairment
IFRIC 12	Service concession arrangements
IFRIC 13	Customer loyalty programmes
IFRIC 14	IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction
IFRIC 15	Agreements for the construction of real estate
IFRIC 16	Hedge of a net investment in a foreign operation



	Title
IFRIC 17	Distributions of non-cash assets to owners
IFRIC 18	Transfers of assets from customers
IFRIC 19	Extinguishing financial liabilities with equity instruments
SIC 15	Operating leases – incentives
SIC 31	Revenue – barter transactions involving advertising services
SIC 32	Intangible assets – website costs

## 6.4 The Conceptual Framework

As well as issuing accounting standards, the IASB and CASL have issued the Conceptual Framework for Financial Reporting. This contains the fundamental principles and concepts that underlie financial reporting and accounting standards. It provides the framework within which new standards are developed. This is discussed in more detail in Chapter 2.

## 6.5 Guidelines issued by CASL

CASL issues guidelines from time to time relevant to the preparation of financial statements of organisations. For example it has issued a statement of recommended practice (SORP) on the preparation of financial statements of not for profit organisations / non-government organisations (NGOs). These guidelines issued by CASL play a vital role in accountancy profession in Sri Lanka.

# 7 The accountancy profession



**CASL is the only organisation in Sri Lanka with the right to award the Chartered Accountant designation.**

A professional accountant working in practice today will normally work for a number of clients. The accountant may be engaged to prepare a set of accounts for a client's business based on information provided, or to review (audit) a set of accounts. They may also be called on to provide advice to their client.

A professional accountant working in industry is normally required to gather accounting information for the business they work for, process this information and present it as accounts.

In either case, the owners of a business rely on the accountant to provide fair and honest financial information about their investment, which they can use as the basis of economic decisions.

It is the responsibility of a professional accountant to act in the public interest and not exclusively to satisfy the needs of an individual client or employer.

## **7.1 The structure of the accountancy profession**

The Institute of Chartered Accountants of Sri Lanka is a professional accountancy body in Sri Lanka. The Institute was established by Act of Parliament, No. 23 of 1959 as the sole organisation in Sri Lanka with the right to award the Chartered Accountant designation. The Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) is one of the country's foremost and largest professional organisations that has produced over 5,800 chartered accountants. The Institute provides leadership and insight to the accountancy and finance profession in Sri Lanka as well as globally.

The Institute of Chartered Accountants of Sri Lanka enjoys agreements with the Institute of Chartered Accountants of England and Wales, CPA Australia, and several other leading international accountancy bodies.

On the other hand Sri Lanka Accounting and Auditing Standard Monitoring Board is the main supervisory body incorporated under Act.

Five professional accounting bodies offer their qualifications in Sri Lanka. They are,

- The Institute of Chartered Accountants of Sri Lanka. (CASL)
- Association of Accounting Technicians of Sri Lanka (AAT)
- The Institute of Chartered Management Accountants of Sri Lanka. (CMA Sri Lanka)
- Chartered Institute of Management Accountants of UK (CIMA – UK)
- Association of Certified Chartered Accountants – UK (ACCA)

### **7.1.1 The Institute of Chartered Accountants of Sri Lanka (CASL)**

CASL has over 5,000 members and 43,000 students. Most of the members of CASL hold senior positions in the corporate world and public sector organisations. Further fairly significant numbers of part qualified students of CASL work in small and medium sized organisations and public sector organisations.

Only members of CASL can practice as auditors of listed entities in Sri Lanka. A qualified member of the institute who meets the eligibility criteria is entitled to

apply for a practicing certificate. This entitles the holder to work in all areas of public practice in Sri Lanka.

## 7.2 Regulations applicable to the accounting profession

Regulations applicable to the accountancy profession include:

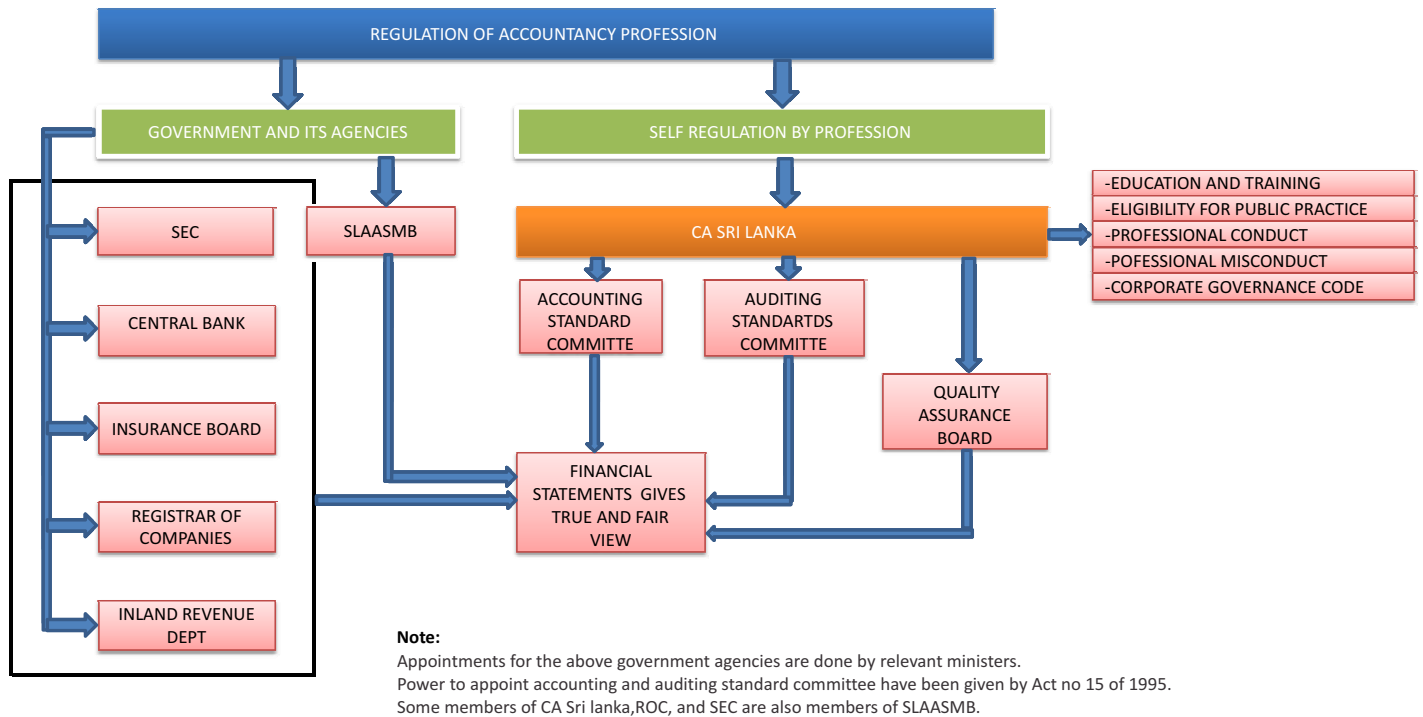
- Companies Act No 07 of 2007
- Sri Lanka Accounting and Auditing Standards Act No 15 of 1995
- Sri Lanka Financial Reporting Standards and Auditing standards
- The provisions of the Act No. 23 of 1959 (see above)

The members and part qualified students of the five professional accounting bodies in Sri Lanka must abide by the codes of professional conducts and ethics published by the respective institutions, in carrying out their work.

CASL is, however, the only national professional body that regulates the profession. It has set up a high level Audit Quality Assurance Board (QAB). The work which QAB does is intended to support but not duplicate the work carried out by the other regulators. In addition to the regulatory bodies mentioned in the previous sections of this chapter, other regulatory bodies include the following:

Organisation	Responsible for
<b>Auditor General</b>	The annual audit of public institutions.
<b>Central Bank of Sri Lanka</b>	Specifying compliance requirements for banks' financial statements (these being in addition to the Companies Act requirements), and issuing guidelines on auditors' statutory duties for bank audits.
<b>Inland Revenue Department</b>	Overseeing the submission of audited financial statements with companies' annual tax returns.
<b>Insurance Board</b>	Specifying the regulatory and supervisory framework for the insurance industry, including regulating the financial reporting practices of insurance companies.
<b>Ministry of Finance and Planning</b>	Appointing members to the Monitoring Board from nominations received from identified institutions including the Central Bank and CASL.
<b>Registrar of Companies</b>	Overseeing the filing of annual financial statements for SBEs.

The following diagram summarises regulation of the accountancy profession in Sri Lanka:



### 7.3 Disciplinary procedures

The Act of Incorporation of the Institute of Chartered Accountants Of Sri Lanka (CASL) states that the council of CASL may disenroll any individual who is a member of CA Sri Lanka, if satisfied that he or she is unfit to practice as a result of professional misconduct.

The Act also states that the council of CASL may only disenroll any person if a Disciplinary committee has, after inquiry, made a report to the council that the person has been guilty of professional misconduct.

Procedures for disciplinary committees are as follows:

- The council appoints three persons from its members to constitute a Disciplinary committee.
- A statement is prepared setting out the charges to be investigated by the Disciplinary committee.
- Where the inquiry is to be held as a result of a petition or complaint alleging misconduct by any person, the secretary of the council transmits a copy of that petition or complaint to that person and to each of the members of the disciplinary committee.

- The secretary of the council must give notice of the first date fixed for the inquiry to the person whose conduct is the subject of the investigation.
- Where any person to whom a notice has been given fails to appear in person or is not represented by counsel, inquiry may be held by the Disciplinary committee in their absence.
- If the council believes that the evidence of any person, or the production of a document, is necessary to enable a matter to be investigated by a Disciplinary committee, it may require the attendance of that person, or the production of such document.
- A disciplinary committee has power to administer oaths or affirmations to all persons who are required to give evidence before such committee.
- Any person whose conduct is the subject of the investigations at an inquiry may be represented one or more advocates at that inquiry.
- The council may authorise any advocate or proctor to assist the Disciplinary committee as to the leading and taking the evidence.
- Any question before a Disciplinary committee is determined by the decision of the majority of the members of that committee.
- Upon the conclusion of an inquiry, the Disciplinary committee prepares and sends to Council a report detailing the findings of the inquiry.

**CHAPTER ROUNDUP**

- ↳ **Financial reporting is a way of recording, analysing and summarising financial data. Financial statements are used by a wide variety of interested parties.**
- ↳ **The regulatory framework of financial reporting refers to the many sources of regulation, including accounting standards, company law and stock exchange rules.**
- ↳ **Several sources of legislation are relevant to the preparation and presentation of financial statements in Sri Lanka.**
- ↳ **SEC Rules govern the listing of securities on the Exchange and continuing listing requirements in order to ensure the creation and maintenance of a market in which securities can be issued and traded in an orderly and fair manner and which secures efficiency and confidence of all stakeholders in the operation and conduct of the market.**
- ↳ **Corporate governance is the system by which companies and other entities are directed and controlled.**
- ↳ **The IASB develops and publishes new International Financial Reporting Standards (IFRSs) according to its six-step due process. CASL can input to this process and, subsequent to issue, adopts IFRSs as SLFRS.**
- ↳ **CASL is the only organisation in Sri Lanka with the right to award the Chartered Accountant designation.**

**PROGRESS TEST**

- 1 What does GAAP stand for?
- 2 Why are the general public interested in financial statements?
- 3 What is corporate governance?
- 4 What is the final stage in the IASB's due process?
- 5 Which of the following best describes GAAP?
  - A Laws relating to accounting requirements
  - B Rules and principles that govern accounting
  - C Accounting standards and interpretations
  - D Principles that underlie accounting standards
- 6 Which of the following is not a mandatory step in the IASB's due process?
  - A Setting the agenda
  - B Planning the project
  - C Developing and publishing the discussion paper
  - D Developing and publishing the exposure draft
- 7 Which of the following is not a source of legislation relevant to accountants in Sri Lanka?
  - A Finance Act No 38 of 1971
  - B Companies Act No 07 of 2007
  - C Sri Lanka Standards and Interpretations Act No 10 of 2001
  - D Inland Revenue Act No 10 of 2002

**ANSWERS TO PROGRESS TEST**

- 1 Generally accepted accounting practice
- 2 For a number of reasons: they may make a substantial contribution to a local economy by providing employment and using local suppliers, or they may have an effect on the environment; for example, as regards pollution.
- 3 It is the system by which companies and other entities are directed and controlled.
- 4 After a standard is issued: monitoring the use of a standard.
- 5 The answer is **B**.
- 6 The answer is **C**. A discussion paper is not a mandatory step in due process.
- 7 The answer is **C**. The legislation dealing with accounting standards is the Sri Lanka Accounting and Auditing Standards Act No 15 of 1995.



# The Conceptual Framework

## INTRODUCTION

The Conceptual Framework for Financial Reporting (the Conceptual Framework) is an attempt to codify existing **generally accepted accounting practice (GAAP)** in order to reappraise current accounting standards and to produce new standards.

Part of the Conceptual Framework deals with measurement, offering one basis of measurement as fair value. SLFRS 13 *Fair value measurement* has recently been issued for use in establishing the fair value of assets and liabilities.

### Knowledge Component

#### 1 Conceptual and Regulatory Framework for Financial Statements

##### 1.1 Conceptual framework of SLFRS

##### 1.1.1

Demonstrate knowledge of the conceptual framework of Sri Lanka Accounting Standards, with emphasis on:

- Objectives of general purpose financial statements
- Underlying assumptions
- Qualitative characteristics of financial statements
- Elements of financial statements
- Recognition and measurement of elements of financial statements
- Concepts of capital and capital maintenance

Knowledge Component			
2 Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)			
2.2	Level B	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1 A conceptual framework	2. 2
2 The Conceptual Framework for Financial Reporting	1.1.1
3 SLFRS 13 <i>Fair value measurement</i>	2. 2

**SLFRS 13 Learning objectives**

- Define fair value.
- Explain the application of the fair value concept to non-financial assets, liabilities and an entity's own equity instruments, financial assets and financial liabilities.
- Explain fair value at initial recognition, valuation techniques and inputs to valuation techniques.
- Outline the disclosures to be made in respect of fair value measurement.

**1 A conceptual framework**

**A conceptual framework is a statement of generally accepted theoretical principles that form the frame of reference for financial reporting.**

A conceptual framework includes theoretical principles such as the definition of an asset or a liability, and recognition criteria for these items together with measurement bases for them.

These theoretical principles provide the basis for the development of new accounting standards and the evaluation of those already in existence. The financial reporting process is concerned with providing information that is useful in the business and economic decision-making process. Therefore, a conceptual framework will form the theoretical basis for determining which events should be accounted for, how they should be measured and how they should be communicated to the user. Although it is theoretical in nature, a conceptual framework for financial reporting has highly practical final aims.

The danger of not having a conceptual framework is demonstrated in the way some countries' accounting standards have developed over recent years; standards tend to be produced in a haphazard and fire-fighting approach. Where an agreed framework exists, the standard-setting body acts as an architect or

designer, rather than a fire-fighter, building accounting rules on the foundation of sound, agreed basic principles.

The lack of a conceptual framework also means that fundamental principles are tackled more than once in different standards, thereby producing contradictions and inconsistencies in basic concepts, such as those of prudence and matching. This leads to ambiguity and it affects the true and fair concept of financial reporting.

Another problem with the lack of a conceptual framework has become apparent in the US. The large number of highly detailed standards produced by the Financial Accounting Standards Board (FASB) has created a financial reporting environment governed by specific rules rather than general principles. This would be avoided if a cohesive set of principles were in place.

A conceptual framework can also bolster standard setters against political pressure from various 'lobby groups' and interested parties. Such pressure would only prevail if it was acceptable under the conceptual framework.

## **1.1 Advantages and disadvantages of a conceptual framework**

### **Advantages**

- (a) The situation is avoided whereby standards are developed on a patchwork basis, where a particular accounting problem is recognised as having emerged, and resources were then channelled into standardising accounting practice in that area, without regard to whether that particular issue was necessarily the most important issue remaining at that time without standardisation.
- (b) As stated above, the development of certain standards (particularly national standards) have been subject to considerable political interference from interested parties. Where there is a conflict of interest between user groups on which policies to choose, policies deriving from a conceptual framework will be less open to criticism that the standard-setter buckled to external pressure.
- (c) Some standards may concentrate on profit or loss, whereas some may concentrate on the valuation of net assets (statement of financial position).

### **Disadvantages**

- (a) Financial statements are intended for a variety of users, and it is not certain that a single conceptual framework can be devised that will suit all users.

- (b) Given the diversity of user requirements, there may be a need for a variety of accounting standards, each produced for a different purpose (and with different concepts as a basis).
- (c) It is not clear that a conceptual framework makes the task of preparing and then implementing standards any easier than without a framework.

## 2 The Conceptual Framework for Financial Reporting



**The Conceptual Framework for Financial Reporting includes chapters on the objective of general purpose financial reporting, qualitative characteristics of financial information, underlying assumption, definition, recognition and measurement of elements of the financial statements and capital maintenance.**

The introduction to the Conceptual Framework for Financial Reporting (the Conceptual Framework) points out the fundamental reason why financial statements are produced worldwide; that is, to satisfy the requirements of external users.

The preface emphasises the way financial statements are used to make economic decisions, and thus financial statements should be prepared to this end. The types of economic decisions for which financial statements are likely to be used include the following.

- Decisions to buy, hold or sell equity investments
- Assessment of management stewardship and accountability
- Assessment of the entity's ability to pay employees
- Assessment of the security of amounts lent to the entity
- Determination of taxation policies
- Determination of distributable profits and dividends
- Inclusion in national income statistics
- Regulations of the activities of entities

Any additional requirements imposed by national governments for their own purposes should not affect financial statements produced for the benefit of other users.

The Conceptual Framework recognises that financial statements can be prepared using a variety of models. Although the most common is based on historical cost and a nominal unit of currency (eg the Sri Lankan rupee), the Conceptual Framework can be applied to financial statements prepared under a range of models.

## 2.1 Purpose and status

The introduction gives a list of the purposes of the Conceptual Framework.

- (a) To assist the Council in the development of future Sri Lanka Accounting Standards and in its review of existing Sri Lanka Accounting Standards.
- (b) To assist the Council in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by Sri Lanka Accounting Standards.
- (c) To assist the Council in developing Sri Lanka Accounting Standards.
- (d) To assist preparers of financial statements in applying Sri Lanka Accounting Standards and in dealing with topics that have yet to form the subject of a Sri Lanka Accounting Standard.
- (e) To assist auditors in forming an opinion as to whether financial statements comply with Sri Lanka Accounting Standards.
- (f) To assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with Sri Lanka Accounting Standards.
- (g) To provide those who are interested in the work of the Council with information about its approach to the formulation of Sri Lanka Accounting Standards.

The Conceptual Framework is not a Sri Lanka Accounting Standard and so does not define standards for any particular measurement or disclosure issue. Nothing in the Conceptual Framework overrides any specific Sri Lanka Accounting Standard.

### 2.1.1 Scope

The Conceptual Framework deals with:

- (a) The objective of financial statements
- (b) The qualitative characteristics of useful financial information
- (c) The definition, recognition and measurement of the elements from which financial statements are constructed
- (d) Concepts of capital and capital maintenance

### 2.1.2 Users and their information needs

Users of accounting information consist of investors, employees, lenders, suppliers and other trade creditors, customers, government and their agencies and the public.



#### QUESTION

#### Users of financial information

Consider the information needs of the users of financial information listed above.

#### ANSWER

- (a) **Investors** are the providers of risk capital.
  - (i) Information is required to help make a decision about buying or selling shares, taking up a rights issue and voting.
  - (ii) Investors must have information about the level of dividend, past, present and future, and any changes in share price.
  - (iii) Investors will also need to know whether the management has been running the company efficiently.
  - (iv) As well as the position indicated by the statement of profit or loss and other comprehensive income, statement of financial position and earnings per share (EPS), investors will want to know about the liquidity position of the company, the company's future prospects, and how the company's shares compare with those of its competitors.
- (b) **Employees** need information about the security of employment and future prospects for jobs in the company, and to help with collective pay bargaining.
- (c) **Lenders** need information to help them decide whether to lend to a company. They will also need to check that the value of any security remains adequate, that the interest repayments are secure, that the cash is available for redemption at the appropriate time and that any financial restrictions (such as maximum debt/equity ratios) have not been breached.
- (d) **Suppliers** need to know whether the company will be a good customer and pay its debts.
- (e) **Customers** need to know whether the company will be able to continue producing and supplying goods.
- (f) **Government's** interest in a company may be one of creditor or customer, as well as being specifically concerned with compliance with tax and company law, ability to pay tax and the general contribution of the company to the economy.

- (g) The **public** at large would wish to have information for all the reasons mentioned above, but it could be suggested that it would be impossible to provide general purpose accounting information that was specifically designed for the needs of the public.

## 2.2 The objective of general purpose financial reporting

The Conceptual Framework states that the objective of general purpose financial reporting is to provide information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

These users need information about:

- The economic resources of the entity
- The claims against the entity
- Changes in the entity's economic resources and claims

Information about the entity's economic resources and the claims against it helps users to assess the entity's liquidity and solvency and its likely need for additional financing.

Information about a reporting entity's financial performance (the changes in its economic resources and claims) helps users to understand the return that the entity has produced on its economic resources. This is an indicator of how efficiently and effectively management has used the resources of the entity and is helpful in predicting future returns.

The Conceptual Framework makes it clear that this information should be prepared on an accruals basis. In other words, the effects of transactions and other events are recognised when they occur (and not when the cash or cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.

Financial statements prepared under the accruals basis show users past transactions involving cash, and also obligations to pay cash in the future and resources which represent cash to be received in the future.

Information about a reporting entity's cash flows during a period also helps users assess the entity's ability to generate future net cash inflows and gives users a better understanding of its operations.



## 2.3 Underlying assumption

Going concern is the underlying assumption in preparing financial statements.



**Going concern.** The entity is normally viewed as a going concern; that is, as continuing in operation for the foreseeable future. It is assumed that the entity has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations. (The Conceptual Framework)

It is assumed that the entity has no intention to liquidate or curtail major operations. If it did, then the financial statements would be prepared on a different (disclosed) basis.

## 2.4 Qualitative characteristics of useful financial information

Qualitative characteristics are the attributes that make financial information useful to users.

Chapter 3 of the Conceptual Framework distinguishes between fundamental and enhancing qualitative characteristics, for analysis purposes. Fundamental qualitative characteristics distinguish useful financial reporting information from information that is not useful or is misleading. Enhancing qualitative characteristics distinguish more useful information from less useful information.

The two fundamental qualitative characteristics are relevance and faithful representation.

### 2.4.1 Fundamental characteristic: relevance



**Relevance.** Relevant information is capable of making a difference in the decisions made by users. It is capable of making a difference in decisions if it has **predictive value, confirmatory value** or both.

The relevance of information is affected by its **nature** and its **materiality**.



**Materiality.** Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.

### 2.4.2 Fundamental characteristic: faithful representation



**Faithful representation.** Financial reports represent **economic phenomena** in words and numbers. To be useful, financial information must not only represent relevant phenomena but must **faithfully represent** the phenomena that it purports to represent.

To be a faithful representation, information must be **complete, neutral and free from error**.

A **complete** depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

A **neutral** depiction is without bias in the selection or presentation of financial information. This means that information must not be manipulated in any way in order to influence the decisions of users.

**Free from error** means there are no errors or omissions in the description of the phenomenon and no errors made in the process by which the financial information was produced. It does not mean that no inaccuracies can arise, particularly where estimates have to be made.

**Substance over form** is **not a separate qualitative characteristic** under the Conceptual Framework. The IASB says that to do so would be redundant because it is **implied in faithful representation**. Faithful representation of a transaction is only possible if it is accounted for according to its **substance and economic reality**.

### 2.4.3 Enhancing characteristic: comparability



**Comparability.** Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or date.

**Consistency**, although related to comparability, **is not the same**. It refers to the use of the same methods for the same items (ie consistency of treatment) either from period to period within a reporting entity or in a single period across entities.

The **disclosure of accounting policies** is particularly important here. Users must be able to distinguish between different accounting policies in order to be able to make a valid comparison of similar items in the accounts of different entities.

Comparability is **not the same as uniformity**. Entities should change accounting policies if those policies become inappropriate.

**Corresponding information** for preceding periods should be shown to enable comparison over time.

#### 2.4.4 Enhancing characteristic: verifiability



**Verifiability.** Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. It means that different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation.

Information that can be independently verified is generally more decision-useful than information that cannot.

#### 2.4.5 Enhancing characteristic: timeliness



**Timeliness.** Timeliness means having information available to decision makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is.

Information may become less useful if there is a delay in reporting it. There is a **balance between timeliness and the provision of reliable information**.

If information is reported on a timely basis when not all aspects of the transaction are known, it may not be complete or free from error.

Conversely, if every detail of a transaction is known, it may be too late to publish the information because it has become irrelevant. The overriding consideration is how best to satisfy the economic decision-making needs of the users.

#### 2.4.6 Enhancing characteristic: understandability



**Understandability.** Classifying, characterising and presenting information clearly and concisely makes it understandable.

Financial reports are prepared for users who have a **reasonable knowledge of business and economic activities** and who review and analyse the information diligently. Some phenomena are inherently complex and cannot be made easy to understand. Excluding information on those phenomena might make the information easier to understand, but without it those reports would be incomplete and therefore misleading. Therefore, matters should not be left out of financial statements simply due to their difficulty, as even well-informed and

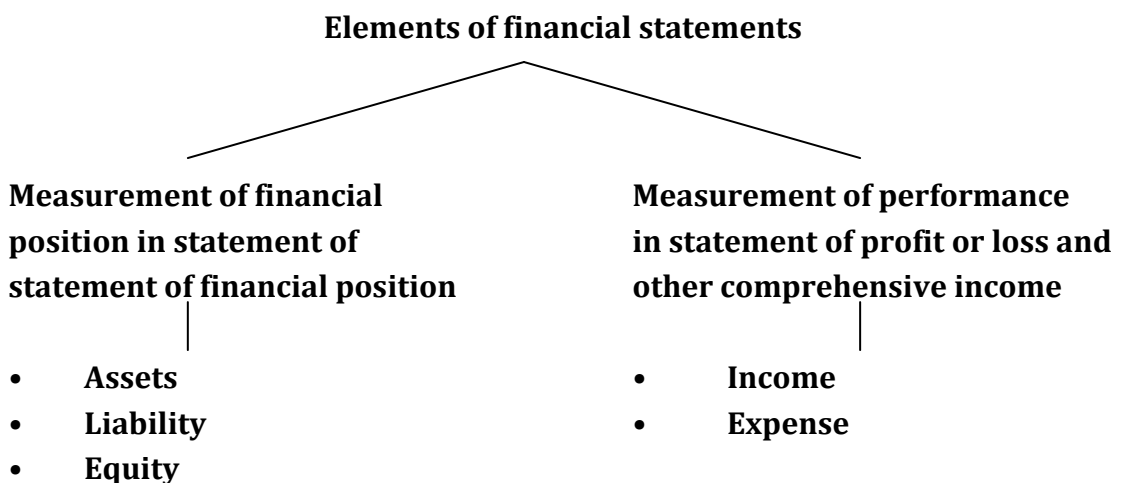
diligent users may sometimes need the aid of an adviser to understand information about complex economic phenomena.

#### 2.4.7 The cost constraint on useful financial reporting

This is a pervasive constraint, not a qualitative characteristic. When information is provided, its benefits must exceed the costs of obtaining and presenting it. This is a **subjective area** and there are other difficulties: others, not the intended users, may gain a benefit; also the cost may be paid by someone other than the users. It is therefore difficult to apply a cost-benefit analysis, but preparers and users should be aware of the constraint.

### 2.5 The elements of financial statements

The Conceptual Framework lays out the elements of financial statements as follows.



*Figure 2.1*

A process of **sub-classification** then takes place for presentation in the financial statements, eg assets are classified by their nature or function in the business to show information in the best way for users to take economic decisions.

#### 2.5.1 Financial position

We need to define the three terms listed under this heading in Figure 2.1 above.



- (a) **Asset.** A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

- (b) **Liability.** A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- (c) **Equity.** The residual interest in the assets of the entity after deducting all its liabilities.

These definitions are important, but they do not cover the criteria for the recognition of any of these items, which are discussed in the next section of this chapter. This means that the definitions may include items that would not actually be recognised in the statement of financial position because they fail to satisfy recognition criteria, particularly the probable flow of any economic benefit to or from the business.

Whether an item satisfies any of the definitions above will depend on the substance and economic reality of the transaction, not merely its legal form. For example, consider finance leases (see Chapter 9).

### 2.5.2 Assets

We can look in more detail at the components of the definitions given above.

Future economic benefit is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the cost of production. Assets are usually employed to produce goods or services for customers; customers will then pay for these. Cash itself renders a service to the entity due to its command over other resources.

The existence of an asset, particularly in terms of control, is not reliant on either of the following:

- (a) Physical form (hence patents and copyrights)
- (b) Legal rights (hence leases)

Transactions or events in the past give rise to assets; those expected to occur in the future do not in themselves give rise to assets. For example, an intention to purchase a non-current asset does not, in itself, meet the definition of an asset.

### 2.5.3 Liabilities

Again we can look more closely at some aspects of the definition. An essential characteristic of a liability is that the entity has a present obligation.

An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

It is important to distinguish between a present obligation and a future commitment. A management decision to purchase assets in the future does not, in itself, give rise to a present obligation.

Settlement of a present obligation will involve the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. This may be done in various ways, not just by payment of cash.

Liabilities must arise from past transactions or events. In the case of, say, recognition of future rebates to customers based on annual purchases, the sale of goods in the past is the transaction that gives rise to the liability.

### Is a provision a liability?

A provision is a present obligation that satisfies the rest of the definition of a liability, even if the amount of the obligation has to be estimated.



### QUESTION

### Elements

Consider the following situations. In each case, do we have an asset or liability within the definitions given by the Conceptual Framework? Give reasons for your answer.

- (a) Pattingha Co has purchased a patent for Rs. 200,000. The patent gives the company sole use of a particular manufacturing process that will save Rs. 30,000 a year for the next five years.
- (b) Kalugala Co paid Mr Adabaye Rs. 100,000 to set up a car repair shop, on condition that priority treatment is given to cars from the company's fleet.
- (c) Deals on Wheels Co provides a warranty with every car sold.

### ANSWER

- (a) This is an asset, albeit an intangible one. There is a past event, control and future economic benefit (through cost savings).
- (b) This cannot be classified as an asset. Kalugala Co has no control over the car repair shop and it is difficult to argue that there are 'future economic benefits'.

- (c) The warranty claims in total constitute a liability; the business has taken on an obligation. It would be recognised when the warranty is issued rather than when a claim is made.

#### 2.5.4 Equity

Equity is defined above as a residual, but it may be sub-classified in the statement of financial position. This will indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity. Some reserves are required by statute or other law, eg for the future protection of creditors. The amount shown for equity depends on the measurement of assets and liabilities. It has nothing to do with the market value of the entity's shares.

#### 2.5.5 Financial performance

Profit is used as a measure of performance, or as a basis for other measures (eg earnings per share). It depends directly on the measurement of income and expenses, which in turn depend (in part) on the concepts of capital and capital maintenance adopted.

The elements of income and expense are therefore defined as follows.



**Income.** Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

**Expenses.** Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Income and expenses can be presented in different ways in the statement of profit or loss and other comprehensive income, to provide information relevant for economic decision making. For example, income and expenses that relate to continuing operations are distinguished from the results of discontinued operations.

#### 2.5.6 Income

Both revenue and gains are included in the definition of income. Revenue arises in the course of ordinary activities of an entity. Gains are increases in economic

benefits include those arising on the disposal of non-current assets. The definition of income also includes unrealised gains, eg on revaluation of marketable securities.

### **2.5.7 Expenses**

As with income, the definition of expenses includes losses as well as those expenses that arise in the course of ordinary activities of an entity. Losses are decreases in economic benefits including those arising on the disposal of non-current assets. The definition of expenses will also include unrealised losses, eg the fall in value of an investment.

## **2.6 Recognition of the elements of financial statements**

Recognition is the process of incorporating in the statement of financial position or statement of profit or loss and other comprehensive income an item that meets the definition of an element and satisfies the following criteria for recognition.

- (a) It is probable that any future economic benefit associated with the item will flow to or from the entity
- (b) The item has a cost or value that can be measured with reliability

Regard must also be given to materiality.

### **2.6.1 Probability of future economic benefits**

Probability here means the degree of uncertainty that the future economic benefits associated with an item will flow to or from the entity. This must be judged on the basis of the characteristics of the entity's environment and the evidence available when the financial statements are prepared.

### **2.6.2 Reliability of measurement**

The cost or value of an item, in many cases, must be estimated. The Conceptual Framework states, however, that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. Where no reasonable estimate can be made, the item should not be recognised, although its existence should be disclosed in the notes, or other explanatory material.

Items may still qualify for recognition at a later date due to changes in circumstances or subsequent events.



### 2.6.3 Assets that cannot be recognised

The recognition criteria do not cover items that many businesses may regard as assets. A skilled workforce is an undoubted asset, but workers can leave at any time so there can be no certainty about the probability of future economic benefits. A company may have come up with a new name for its product which is greatly increasing sales but, as it did not buy the name, the name does not have a cost or value that can be reliably measured, so it is not recognised.

### 2.6.4 Recognition of elements

We can summarise the recognition criteria for assets, liabilities, income and expenses based on the definition of recognition given above.

Item	Recognised in	When
<b>Asset</b>	The statement of financial position	It is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.
<b>Liability</b>	The statement of financial position	It is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.
<b>Income</b>	The statement of profit or loss and other comprehensive income	An increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.
<b>Expenses</b>	The statement of profit or loss and other comprehensive income	A decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.

## 2.7 Measurement of the elements of financial statements

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of profit or loss and other comprehensive income.

This involves the selection of a particular basis of measurement. A number of these are used to different degrees and in varying combinations in financial statements. They include:

- (a) **Historical cost.** Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.
- (b) **Current cost.** Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
- (c) **Realisable (settlement) value.**
  - **Realisable value.** The amount of cash or cash equivalents that could currently be obtained by selling an asset in an orderly disposal.
  - **Settlement value.** The undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.
- (d) **Present value.** A current estimate of the present discounted value of the future net cash flows in the normal course of business.

Historical cost is the most commonly adopted measurement basis, but this is usually combined with other bases, eg inventory is carried at the lower of cost and net realisable value.

Recent standards use the concept of fair value, which is defined by SLFRS 13 as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'. This is considered in more detail in Section 3 of this chapter.



### 2.7.1 Example: measurement

A machine was purchased on 1 January 20X8 for Rs. 3m. That was its original cost. It has a useful life of 10 years and under the historical cost convention it will be carried at original cost less accumulated depreciation. So in the financial statements at 31 December 20X9, it will be carried at:

$$\text{Rs. } 3\text{m} - (0.3 \times 2) = \text{Rs. } 2.4\text{m}$$

The current cost of the machine, which will probably also be its fair value, will be fairly easy to ascertain if it is not too specialised. For instance, two-year-old

machines like this one may currently be changing hands for Rs. 2.5m, so that will be an appropriate fair value.

The net realisable value (NRV) of the machine will be the amount that could be obtained from selling it, less any costs involved in making the sale. If the machine had to be dismantled and transported to the buyer's premises at a cost of Rs. 200,000, the NRV would be Rs. 2.3m.

The replacement cost of the machine will be the cost of a new model less two year's depreciation. The cost of a new machine may now be Rs. 3.5m. Assuming a 10-year life, the replacement cost will therefore be Rs. 2.8m.

The present value of the machine will be the discounted value of the future cash flows that it is expected to generate. If the machine is expected to generate Rs. 500,000 per annum for the remaining 8 years of its life and if the company's cost of capital is 10%, present value will be calculated as:

$$\text{Rs. } 500,000 \times 5.335^* = \text{Rs. } 2,667,500$$

\* Cumulative present of Re. 1 per annum for 8 years discounted at 10%.

## 2.8 Capital maintenance

Capital maintenance refers to the concept that profits can only be made when the capital of an organisation is restored to, or maintained at, the level that it was at the start of an accounting period. The concept is commonly separated into two types: physical and financial capital maintenance.

Under the physical capital maintenance concept, a profit is earned only when the operating capability of an organisation at the end of a period exceeds the operating capability at the start of the period. This may be based on, for example, number of units of output per day.

Under the financial capital maintenance concept, a profit is earned when the money value of net assets at the end of a period exceeds their money value at the start of the period after excluding capital injections and dividends paid during the period. This may be measured in nominal monetary units or units of constant purchasing power.

Most entities adopt a financial concept of capital.

### 3 SLFRS 13 *Fair value measurement*



**SLFRS 13 *Fair value measurement* provides guidance on determining fair value where other standards require an item to be measured at fair value.**

As we have seen, the Conceptual Framework suggests a number of acceptable measurement bases for elements of the financial statements. Many standards require or permit the use of fair value, including:

- LKAS 16 *Property, plant and equipment* (Chapter 5)
- LKAS 40 *Investment property* (Chapter 6)
- LKAS 41 *Agriculture* (Chapter 10)
- LKAS 39 *Financial instruments* (Chapter 14)

SLFRS 13 sets out to define fair value and to set out in a single accounting standard a framework for measuring fair value where it is required by another standard. SLFRS 13 does not, however, apply to the measurement of fair value in respect of the following:

- (a) Share-based payment transactions within the scope of SLFRS 2 *Share-based payment* (Chapter 16)
- (b) Leasing transactions within the scope of LKAS 17 *Leases* (Chapter 9); and
- (c) Net realisable value as in LKAS 2 *Inventories* (Chapter 10); or value in use as in LKAS 36 *Impairment of assets* (Chapter 8).

In each of these cases, the relevant standard provides the required guidance.

#### 3.1 Definition



**Fair value** is defined as:

**'The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.'**

This is an exit price, ie the price that an entity disposing of an asset or liability would achieve rather than the price that an entity acquiring an asset or liability would have to pay.

## 3.2 Measurement

Fair value is a market-based measurement, not an entity-specific measurement.

Therefore, fair value is measured using the assumptions that market participants would use when pricing the asset under current market conditions, taking into account any relevant characteristics of the asset. Therefore, whether an entity intends to hold an asset or settle a liability is irrelevant when measuring fair value.

A fair value measurement requires an entity to determine:

- (a) The item being measured
- (b) For a non-financial asset, the highest and best use of the asset and whether the asset is used in combination with other assets
- (c) The market in which an orderly transaction would take place for the asset or liability
- (d) The appropriate valuation technique to use when measuring fair value

## 3.3 The item being measured

The item for which fair value is determined is referred to in SLFRS 13 as the 'unit of account'. It is defined as the level at which an asset or liability is aggregated or disaggregated in an SLFRS for accounting purposes.

In most cases, the unit of account is an individual asset or liability (eg an individual property), but in some instances it may be a group of assets or liabilities (eg the assets and liabilities of an SLFRS 5 disposal group).



### 3.3.1 Example: unit of account

A premium or discount on a large holding of the same shares (because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity) is not considered when measuring fair value: the quoted price per share in an active market is used.

However, a control premium is considered when measuring the fair value of a controlling interest, because the unit of account is the controlling interest. Similarly, any non-controlling interest discount is considered when measuring a non-controlling interest.

## 3.4 Highest and best use

In the case of non-financial assets, fair value is determined based on the highest and best use of the asset from the perspective of a market participant.

The highest and best use should be:

- Physically possible
- Legally permissible
- Financial feasible

In many cases, it can be assumed that the current use of an asset is its highest and best use.



### 3.4.1 Example: highest and best use

An entity acquires land that is currently developed for industrial use as a site for a factory. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that evidence, the entity believes that the land could be developed for residential use.

The fair value of the land based on highest and best use is therefore the higher of:

- The value of the land as currently developed for industrial use, or
- The value of the land as a vacant site for residential use taking into account the costs of demolishing the factory and other costs to convert the land to a vacant site.

## 3.5 The market

It is assumed that the transaction to sell an asset or transfer a liability takes place either:

- (a) In the **principal market** for the asset or liability, or
- (b) In the absence of a principal market, in the **most advantageous** market for the asset or liability.

The **principal market** is the market with the greatest volume and level of activity for that asset or liability. If a principal market exists, then the price in that market **must** be used to establish fair value.

The **most advantageous market** is the market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability after taking into account transaction and transport costs. Although transaction costs are taken into account when determining the most advantageous market, fair value once determined is not adjusted for these costs.

- (a) In most cases, the principal market and the most advantageous market will be the same.

- (b) It is presumed that the market in which an entity normally transacts is the principal or most advantageous market, unless there is evidence to the contrary.



### QUESTION

### Principal or most advantageous market

An asset is sold in two active markets, Market A and Market B, at Rs. 98 and Rs. 97, respectively. Alutwewa Plantations PLC does business in both markets and can access the price in those markets for the asset at the measurement date as follows.

	<i>Market A</i>	<i>Market B</i>
	Rs	Rs
Price	98	97
Transaction costs	(4)	(3)
Transport costs (to transport the asset to that market)	<u>(4)</u>	<u>(2)</u>
	<u>90</u>	<u>92</u>

### Required

- (a) What is the fair value of the asset if Market A is the principal market?
- (b) What is the fair value of the asset if neither Market A nor Market B is the principal market?

### ANSWER

- (a) If Market A is the principal market for the asset, the fair value of the asset would be Rs. 94, measured as the price that would be received in that market (Rs. 98) less transport costs (Rs. 4) and ignoring transaction costs.
- (b) If neither Market A nor Market B is the principal market for the asset, Alutwewa Plantations must measure the fair value of the asset using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account both transaction costs and transport costs (ie the net amount that would be received in the respective markets). The maximum net amount (after deducting both transaction and transport costs) is obtainable in Market B (Rs. 92, as opposed to Rs. 90). But this is not the fair value of the asset. The fair value of the asset is obtained by deducting transport costs but not transaction costs from the price received for the asset in Market B: Rs. 97 less Rs. 2 = Rs. 95.

### 3.6 Valuation techniques

SLFRS 13 does not require the use of a particular valuation technique, however it does require a technique that is 'appropriate in the circumstances' and that maximises the use of relevant observable inputs (see Section 3.6.1).

The standard discusses three widely used valuation techniques:

**(1) The market approach**

A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities.

**(2) The cost approach**

A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset.

**(3) The income approach**

A valuation technique that converts future amounts (eg cash flows or income) to a single discounted amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

Whichever valuation technique is selected, it should be applied consistently from period to period.

#### 3.6.1 Inputs to valuation techniques

The standard requires that in any valuation technique, the use of relevant observable inputs should be maximised and unobservable inputs minimised.

To increase consistency and comparability in fair value measurements and related disclosures, SLFRS 13 establishes a fair value hierarchy that categorises into three levels the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability.

An item's fair value is categorised according to the lowest level input. Therefore, a fair value measurement of quoted shares based on the unadjusted share price is a



Level 1 measurement, whereas a fair value measurement of an unquoted investment using a valuation technique based on discounted cash flows is a Level 3 measurement.

### **3.7 Measurement of financial instruments**

#### **3.7.1 Financial assets**

The following should be considered where a financial asset is being fair valued.

- (a) If a quoted item has a bid price (the price that buyers are willing to pay) and an ask price (the price that sellers are willing to achieve), the price within the bid-ask spread that is most representative of fair value is used to measure fair value. The use of bid prices for financial assets and the use of ask prices for financial liabilities is permitted but not required. SLFRS 13 does not preclude the use of mid-market pricing.
- (b) In the case of equity shares, a control premium is considered when measuring the fair value of a controlling interest. Similarly, any non-controlling interest discount is considered where measuring a non-controlling interest.
- (c) The valuation of unlisted equity investments involves significant judgement, and different valuation techniques are likely to result in different fair values, however this does not mean that any of the techniques are incorrect. Certain techniques are better suited to particular types of business, for example an asset based approach is relevant to property companies while an income approach is more relevant to service businesses. It is likely that valuation will be based on some unobservable inputs and as a result the overall fair value will be classified as a Level 3 measurement.

#### **3.7.2 Liabilities and own equity instruments**

Liabilities and own equity instruments must be measured on the assumption that the liability or equity is transferred to a market participant at the measurement date and therefore:

- (a) A liability would remain outstanding and the market participant would be required to fulfil the obligation
- (b) An entity's own equity instrument would remain outstanding and the market participant would take on the rights and responsibilities associated with the instrument

This differs (sometimes significantly so) from a measurement that is based on the assumption of settlement of a liability or cancellation of an entity's own equity instrument.

SLFRS 13 further requires that the fair value of a liability must factor in non-performance risk. Anything that could influence the likelihood of an obligation being fulfilled is considered a non-performance risk. This could include the risk of physically extracting or transporting an asset or the entity's own credit risk.

The specific approach to fair value liabilities and an entity's own equity instruments sometimes differs from the concepts to fair value an asset and is summarised in the following flowchart.

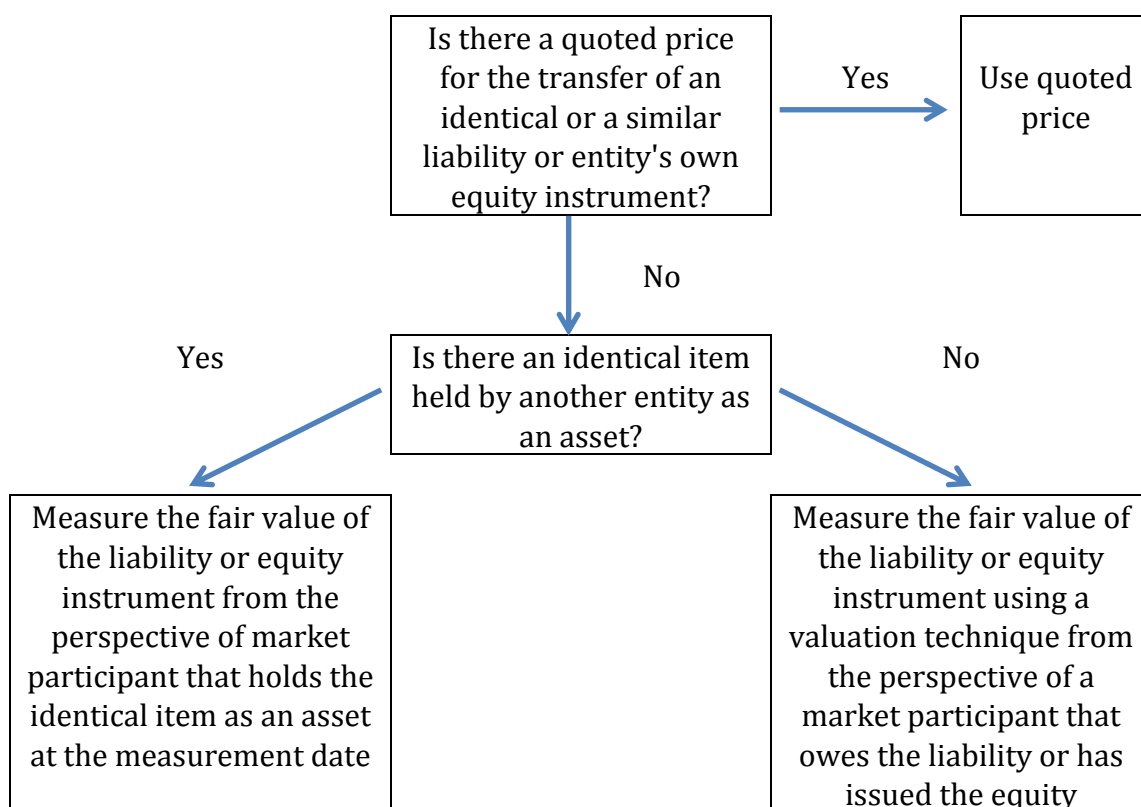


Figure 2.2

### 3.8 Disclosure

An entity should disclose information that helps users of the financial statements assess both of the following.

- (a) For assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements.

- (b) For recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.



## CHAPTER ROUNDUP

- ↳ **A conceptual framework is a statement of generally accepted theoretical principles that form the frame of reference for financial reporting.**
- ↳ **The Conceptual Framework for Financial Reporting includes chapters on the objective of general purpose financial reporting, qualitative characteristics of financial information, underlying assumption, definition, recognition and measurement of elements of the financial statements and capital maintenance.**
- ↳ **SLFRS 13 *Fair value measurement* provides guidance on determining fair value where other standards require an item to be measured at fair value.**


**PROGRESS TEST**

- 1 The needs of which category of user are most important when preparing financial statements?
- 2 What makes information relevant?
- 3 The cost or value of items in the financial statements is never estimated. True or false?
- 4 What is the most common basis of measurement used in the financial statements?
- 5 What is the principal market for the purposes of fair value measurement?
- 6 For what type of item is the highest and best use relevant when measuring fair value?
- 7 How would you define Level 1, 2 and 3 outputs in the SLFRS 13 fair value hierarchy?
- 8 Which of the following are fundamental qualitative characteristics of financial information?
  - 1 Going concern
  - 2 Faithful representation
  - 3 Materiality
  - 4 Relevance
  - A 1 and 4
  - B 1 and 3
  - C 2 and 3
  - D 2 and 4
- 9 Which of the following is most similar to fair value as defined by SLFRS 13?
  - A Historical cost
  - B Current cost
  - C Realisable value
  - D Present value
- 10 A property is measured at the price per square metre for the property derived from prices in observed transactions involving comparable buildings in similar locations. What level of fair value measurement is this classified as?
  - A Level 1
  - B Level 2
  - C Level 3

## ANSWERS TO PROGRESS TEST

- 1 Investors
- 2 Information is relevant if it has a predictive or confirmatory value.
- 3 False: monetary values are often estimated
- 4 Historical cost
- 5 The market with the greatest volume of transactions
- 6 Non-financial assets
- 7 Level 1: unadjusted quoted prices  
Level 2: inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly  
Level 3: unobservable inputs
- 8 The answer is **D**. Going concern is the underlying assumption; materiality is not a qualitative characteristic but is a consideration in relevance.
- 9 The answer is **C**. Realisable value is the amount of cash or cash equivalents that could currently be obtained by selling an asset in an orderly disposal. Fair value is defined as an exit price, ie the price that could be obtained from selling an asset.
- 10 The answer is **B**. Inputs are observed, however are not quoted, and therefore this is a Level 2 measurement.

# Non-financial Reporting

## INTRODUCTION

Non-financial, or narrative, reporting is increasingly common, particularly amongst larger and listed companies. Such companies often include sections in their annual reports in which environmental, social and ethical policies are explained. Performance in these areas may be linked to financial performance; this is known as integrated reporting.

### Knowledge Component

#### 4 Financial Statement Analysis and Non-financial Reporting

##### 4.2 Non-financial reporting

##### 4.2.1

Outline the progress towards non-financial reporting standards, including sustainability reporting and integrated reporting.

**CHAPTER CONTENTS**

1	Introduction to non-financial reporting	4.2.1
2	Sustainability reporting	4.2.1
3	Integrated reporting	4.2.1

**LEARNING  
OUTCOME****1 Introduction to non-financial reporting**

**Non-financial reporting is an increasingly popular aspect of an annual report.**

In recent years, users of financial statements have become increasingly interested not only in the financial performance of a company, but also in its approach to corporate social responsibility, and in particular how it approaches social, environmental and ethical issues.

Understanding a company's approach to these issues is relevant to users because they want assurance that the company that they have invested in or have dealings with complies with legal requirements, ethical standards and other international norms.

In addition, investors and other parties increasingly expect companies to actively engage in actions that have a positive impact on the environment, consumers, communities, employees and other stakeholders.

**1.1 The development of non-financial reporting**

Initially, reporting on corporate social responsibility took the form of voluntary environmental and then social reports.

Environmental reports detail the effect, both positive and negative, on the environment of a company's operations, such as levels of waste and pollution, and recycling levels. The first environmental reports were published in the 1980s, by companies in the chemical industry, in an attempt to address image problems.

Social reports detail the impact of a business on society, for example through social networks, the effect of employment policies and business practice on health and human rights, philanthropic donations and community support.

More recently, the concept of social and environmental reporting has expanded to form sustainability reporting. This incorporates the wider issue of sustainability in an environmental, social and ethical context. It addresses the issue of whether a business can meet the needs of the present world without compromising the



ability of future generations to meet their own needs. For example, a company that monitors and its water use or uses energy efficient technology is contributing to environmental sustainability. Sustainability reporting is covered in Section 2.

The most recent development in corporate social responsibility reporting is the emergence of integrated reporting. This links environmental, social and sustainability issues to financial strategy and results, and is dealt with in Section 3.

## 2 Sustainability reporting



**Sustainability reporting is a way for organisations to become more sustainable and contribute to a sustainable global economy.**

Sustainability is the ability for something to last for a long time or indefinitely. Increasingly, organisations want to make their operations sustainable and contribute to sustainable development. Sustainability reporting helps organisations to measure, understand and communicate their economic, environmental, social and governance performance. It also helps them to measure the impacts they cause, set goals and manage change.

### 2.1 What is sustainability reporting?

A sustainability report is a report about the economic, environmental and social impacts (both negative and positive) caused by an organisation's everyday activities. It also presents the organisation's values and governance model and demonstrates the link between strategy and commitment to a sustainable global economy.

In order to produce a sustainability report, an organisation must set up a programme of data collection, communication and responses. As a result, their sustainability performance is monitored on an ongoing basis and data can be used to decide strategy and policies and improve performance.

### 2.2 Sustainability reporting guidance

The Global Reporting Initiative (GRI) is 'a long-term, multi-stakeholder, international undertaking whose mission is to develop and disseminate globally applicable Sustainability Reporting Guidelines for voluntary use by organisations reporting on the economic, environmental and social dimensions of their activities, products and services'.

The GRI's first set of guidelines, known as 'G1', were first issued in 2000, with second, third and fourth generation guidelines subsequently issued to expand and update the guidance provided.

The current guidelines are 'G4'. They set out the framework of a sustainability report. It consists of the following 'general standard disclosures'.

Strategy and analysis	Includes a statement from the CEO on sustainability and a description of the key impacts, risks and opportunities.
Organisational profile	The organisation's structure including brands, location of operations, geographical markets served and size of operations.
Identified material aspects and boundaries	Details entities included in the financial statements but not in the report and the parameters of the report including materiality.
Stakeholder engagement	A list of stakeholder groups, approaches to stakeholder engagement and key topics and concerns raised through stakeholder engagement.
Report profile	The reporting period and cycle and policy/practice as regards seeking external assurance for the report.
Governance	Governance structure of the organisation, details of governance processes.
Ethics and Integrity	Details of the organisation's values, principles, standards and norms of behaviour and the mechanisms for seeking advice on unlawful/unethical behaviour such as helplines.

A sustainability report also includes 'specific standard disclosures', as follows.

Economic	Economic performance Market presence Indirect economic impacts Procurement practices
Environmental	Materials Energy Water Biodiversity Emissions, effluents, and waste Products and services

	Compliance Transport Overall Supplier environmental assessment Environmental grievance mechanisms
Social: labour practices and decent work	Employment Labour/management relations Occupational health and safety Training and education Diversity and equal opportunity Equal remuneration for men and women Supplier assessment for labour practices Labour practices grievance mechanisms
Social: human rights	Investment Non-discrimination Freedom of association and collective bargaining Child labour Forced or compulsory labour Security practices Indigenous rights Assessment Supplier human rights Human rights grievance mechanisms
Social: society	Local communities Anti-corruption Public policy Anti-competitive behaviour Compliance Supplier assessment for impacts on society Grievance mechanisms for impacts on society
Social: product responsibility	Customer health and safety Product and service labelling Marketing communications Customer privacy Compliance

### 3 Integrated reporting



**Integrated reporting links social, environmental and ethical performance to financial performance. It is sometimes referred to as triple bottom line reporting (profit, planet and people).**

Integrated reporting is the latest development in corporate social responsibility reporting. This takes sustainability reporting a step further by linking it to financial performance. It is promoted by the International Integrated Reporting Council (the IIRC), which currently has over 100 household name companies taking part in its integrated reporting pilot programme, including Microsoft, Hyundai and Unilever.

An integrated report is described by the IIRC as 'a concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, leads to the creation of value in the short, medium and long term'.

This form of reporting is sometimes referred to as 'triple bottom line reporting', ie reporting on 'profit, the planet and people' (financial, environmental and social issues).

#### 3.1 Drivers of integrated reporting

Integrated reporting has developed as a result of demand from stakeholders. One reason for this demand is the growing popularity of ethical investing, ie making an investment decision based not only on financial factors but also on social, environmental and ethical factors. It is not, however, only investors who have an interest in this area; companies entering into alliances or supply contracts with other companies increasingly consider whether that company's approach to sustainability is in line with its own.

From the reporting company's perspective, it is also the case that environmental, ethical and social issues represent a source of risk with potential financial implications if they are ignored.

#### 3.2 Integrated reporting framework

The IIRC issued the Integrated Reporting Framework (the IR Framework) in 2013. Its aim in doing so was to accelerate the global adoption of integrated reporting.

The IR Framework:

- (a) Provides guidance on using the Framework and the fundamental concepts of integrated reporting

- (b) Discusses guiding principles and content elements related to the preparation and presentation of an integrated report

### 3.2.1 Fundamental concepts

The fundamental concepts of integrated reporting are:

#### (a) Value creation for the organisation and others

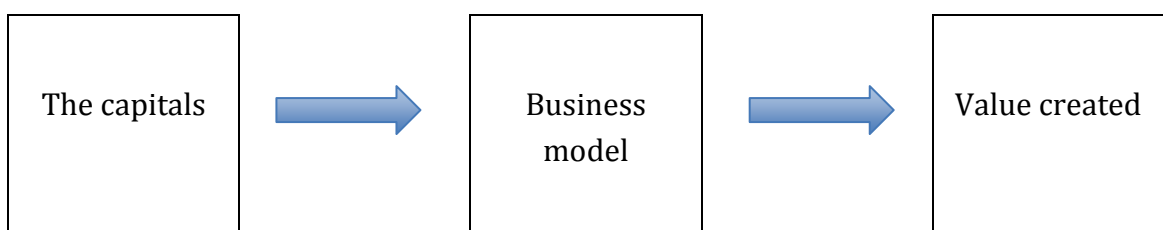
The ability of an organisation to create value for itself is linked to the value it creates for others. This happens through a wide range of activities, interactions and relationships in addition to those that are directly associated with changes in capital, eg sales made. These include the effect of outputs on customer satisfaction, organisational reputation, the imposition of supply chain requirements and initiatives with business partners.

#### (b) The capitals

All organisations depend on various forms of capital for their success, and these should be considered when preparing an integrated report. These include financial, manufactured, intellectual, human, social, relationship and natural capital. These capitals increase, decrease or transform through the activities and outputs of the organisation. The capitals are interlinked, for example human capital increases through the provision of employee training, but financial capital decreases due to the cost.

#### (c) The value creation process

This is the linkage between the capitals, the business model and ability to create value:



*Figure 3.1*

### 3.2.2 Guiding principles

Seven guiding principles underlie the preparation and presentation of an integrated report.

- (1) Strategic focus and future orientation – an integrated report should provide insight into an entity's strategy and how it relates to the ability to create value and affects the capitals.

- (2) Connectivity of information – an integrated report should show a holistic picture of the combination, interrelatedness and dependencies between the factors that affect the organisation's ability to create value over time.
- (3) Stakeholder relationships – an integrated report should provide insight into the nature and quality of an organisation's relationships with its key stakeholders.
- (4) Materiality – an integrated report should disclose information about matters that substantively affect the organisation's ability to create value over the short, medium and long term.
- (5) Conciseness – an integrated report should be concise.
- (6) Reliability and completeness – an integrated report should include all material matters, both positive and negative in a balanced way and without material error.
- (7) Consistency and comparability – the information in an integrated report should be presented on a basis that is consistent over time and in a way that enables comparison with other organisations to the extent it is material to the organisation's own ability to create value over time.

### 3.2.3 Content elements

An integrated report must include the following eight key content elements.

- (1) Organisational overview and external environment – what does the organisation do and what are the circumstances under which it operates?
- (2) Governance – how does the organisation's governance structure support its ability to create value in the short, medium and long term?
- (3) Business model – what is the organisation's business model?
- (4) Risks and opportunities – what are the specific risks and opportunities that affect the organisation's ability to create value over the short, medium and long term, and how is the organisation dealing with them?
- (5) Strategy and resource allocation – where does the organisation want to go and how does it intend to get there?
- (6) Performance – to what extent has the organisation achieved its strategic objectives for the period and what are its outcomes in terms of effects on the capitals?
- (7) Outlook – what challenges and uncertainties is the organisation likely to encounter in pursuing its strategy and what are the potential implications for its business model and future performance?

- (8) Basis of preparation and presentation – how does the organisation determine what matters to include in the integrated report and how are such matters quantified or evaluated?

### **3.3 Benefits of integrated reporting**

For the investor, integrated reporting connects strategy, governance and performance and allows the investor to understand how the strategy being pursued creates value over time.

For the reporting entity, integrated reporting is a form of reporting that helps management to understand and implement strategy and drive internal performance. In turn, this helps to attract investment capital.

Other benefits may include customer loyalty, improved stakeholder relations, reduced operational and strategic risk, expanded business and strategic alliance opportunities and an enhanced reputation.

**CHAPTER ROUNDUP**

- ↳ **Non-financial reporting is an increasingly popular aspect of an annual report.**
- ↳ **Sustainability reporting is a way for organisations to become more sustainable and contribute to a sustainable global economy.**
- ↳ **Integrated reporting links social, environmental and ethical performance to financial performance. It is sometimes referred to as triple bottom line reporting (profit, planet and people).**




**PROGRESS TEST**

- 1 What is sustainability?
- 2 Which body provides guidelines on sustainability reporting?
- 3 What broad topics should the specific standard disclosures within the G4 guidance cover?
- 4 What are the fundamental concepts of integrated reporting?
- 5 How many key content elements of an integrated report are there?
- 6 Which of the following is not a general standard disclosure as required by the G4 guidelines?
  - A Ethics and integrity
  - B Governance
  - C Stakeholder engagement
  - D Economic performance
- 7 Integrated reporting is sometimes referred to as 'triple bottom line reporting'. What does this refer to?
  - A Profit, power and people
  - B Power, people and planet
  - C Profit, planet and power
  - D Profit, planet and people
- 8 Which of the following are all guiding principles of an integrated report according to the IR Framework?
  - A Materiality, conciseness and fair presentation
  - B Reliability, completeness and verifiability
  - C Consistency, comparability and materiality
  - D Comparability, reliability and understandability

**ANSWERS TO PROGRESS TEST**

- 1** Sustainability is the ability for something to last for a long time or indefinitely.
- 2** The Global Reporting Initiative (GRI)
- 3** Economic, environmental and social issues
- 4** Value creation, the capitals and the value creation process
- 5** Eight (see Section 3.2.3)
- 6** The answer is **D**. This is a specific standard disclosure
- 7** The answer is **D**.
- 8** The answer is **C**. See Section 3.2.2.

# Presentation of Financial Statements

## INTRODUCTION

This chapter considers four accounting standards. Two were included at the KE1 level and are revised, and two are new standards at the KB1 level:

- LKAS 1 *Presentation of financial statements* prescribes the content and format of company financial statements.
- LKAS 8 *Accounting policies, changes in accounting estimates and errors* deals with the selection of accounting policies and adjustments for changes in these and accounting estimates and the correction of errors.
- LKAS 21 *The effects of changes in foreign exchange rates* deals with accounting for foreign currency transactions.
- LKAS 34 *Interim financial reporting* prescribes the content of mid-year financial reports for those companies that publish them.

Knowledge Component			
<b>2</b>	<b>Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)</b>		
<b>2.1</b>	<b>Level A</b>		
		2.1.1	Advise on the application of Sri Lanka Accounting Standards in solving complicated matters.
		2.1.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in conformity with Sri Lanka Accounting Standards.
		2.1.3	Evaluate the impact of application of different accounting treatments.

Knowledge Component			
2.2	Level B	2.1.4	Propose appropriate accounting policies to be selected in different circumstances.
		2.1.5	Evaluate the impact of use of different expert inputs to financial reporting.
		2.1.6	Advise on the appropriate application and selection of accounting/reporting options given under standards.
		2.1.7	Design the appropriate disclosures to be made in the financial statements.
		2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.
3 Preparation of Financial Statements			
3.2	Entity financial statements	3.2.1	Prepare single entity financial statements (Statement of Financial Position, Statement of Comprehensive Income, Statement of Changes in Equity and Statement of Cash Flows) in accordance with the prescribed structure and content as per relevant accounting standards.

CHAPTER CONTENTS	LEARNING OUTCOME
1 LKAS 1 <i>Presentation of financial statements</i>	2.1
2 The statement of financial position	2.1, 3.2.1
3 The statement of profit or loss and other comprehensive income	2.1, 3.2.1
4 The statement of changes in equity and notes	2.2, 3.2.1
5 LKAS 8 <i>Accounting policies, changes in accounting estimates and errors</i>	2.2
6 Foreign currency transactions	2.2
7 Interim financial statements	2.2

## LKAS 1 Learning objectives

- Outline the general features of financial statements.
- Outline the content of a complete set of financial statements.
- Differentiate profit or loss items and other comprehensive income items.
- Differentiate current and non-current assets/liabilities.
- Compile elements of financial statements in compliance with the standard.

## LKAS 8 Learning objectives

- Contrast changes in accounting policy, changes in accounting estimate and error.
- Explain the importance of selection and application of appropriate accounting policies.
- Demonstrate how to adjust change in accounting policies, accounting estimates and errors in financial statements.
- Demonstrate the effect of change in the financial statements after making due adjustments for changes in accounting policies, accounting estimates and errors.
- Outline the disclosures to be made in respect of change in accounting policies, accounting estimates and errors.

## LKAS 21 Learning objectives

- Describe functional currency, presentation currency and foreign currency.
- Describe monetary and non-monetary items.
- Record foreign currency transactions in functional currency.
- Compute gain/losses arising on translation.

## LKAS 34 Learning objectives

- Define interim period and interim financial statements.
- List the minimum components of an interim financial report.
- State periods for which interim financial statements are required to be presented.
- Discuss how to decide materiality for interim financial statements.

### 1 LKAS 1 *Presentation of financial statements*



LKAS 1 states that a complete set of financial statements includes a statement of financial position, a statement of profit or loss and other comprehensive income, a statement of changes in equity, a statement of cash flows and disclosure notes.

LKAS 1 was covered in detail at KE1. The first sections of this chapter revise the topic.

#### 1.1 A complete set of financial statements

A complete set of financial statements includes the following:

- Statement of financial position
- Statement of profit or loss and other comprehensive (either as a single statement or as two separate statements: the statement of profit or loss and the statement of other comprehensive income)
- Statement of changes in equity
- Statement of cash flows
- Notes, including a summary of significant accounting policies and other explanatory information

Comparative information should be provided for all amounts reported in the financial statements and in the notes. Comparative information is the relevant amount for the previous period.

LKAS 1 gives guidance on the format and content of all the financial statements other than the statement of cash flows, which is covered by LKAS 7. LKAS 1 also provides guidance on the general features of financial statements.

## 1.2 General features of financial statements

Within this section, the general features of financial statements as provided in LKAS 1 are considered.

### 1.2.1 Fair presentation and compliance with SLFRSs

Financial statements must present a true and fair view of the financial position, performance and cash flows of an entity. In other words, they must faithfully represent the effects of transactions and other events in accordance with the basic principles of the Conceptual Framework.

The application of SLFRSs and additional disclosure where necessary is presumed to result in a true and fair view, and an entity which complies with SLFRSs should state this fact in the notes to the accounts. Inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used or by notes or explanatory material.

In extremely rare circumstances, compliance with a requirement of an SLFRS or Interpretation may be so misleading that it would conflict with the objective of financial statements set out in the Conceptual Framework, in which case the entity should depart from that specific requirement.

In the case of such a departure, the entity must disclose the following.

- That management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows.
- That it has complied with applicable SLFRSs except that it has departed from a particular requirement to achieve a true and fair view.
- Full details of the departure.
- The impact on the financial statements for each item affected and for each period presented.

If the relevant regulatory framework prohibits departure from the requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing:

- (1) The relevant SLFRS, the nature of the requirement and the reason why complying with the requirement is misleading.

- (2) For each period presented, the adjustments to each item in the financial statements that would be necessary to achieve a true and fair view.

### 1.2.2 Going concern

Financial statements should be prepared on the going concern basis unless management either intends to liquidate the entity or cease trading or has no realistic alternative but to do so.

Where material uncertainties result in significant doubt on an entity's ability to continue as a going concern, those uncertainties must be disclosed.

Where financial statements are not prepared on the going concern basis, that fact must be disclosed together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern.

### 1.2.3 Accrual basis of accounting

All of the financial statements other than the statement of cash flows should be prepared using the accruals basis of accounting, ie items in the financial statements are recognised in accordance with the definitions and recognition criteria in the Conceptual Framework.

### 1.2.4 Materiality and aggregation

LKAS 1 provides the following definition of material.



**Material.** Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

The standard requires that:

- (a) Each material class of similar items is presented separately
- (b) Items of a dissimilar nature or function are presented separately unless they are immaterial

If a line item in the financial statements is not individually material, it is aggregated with other items; an item that is not sufficiently material to warrant separate presentation in an individual statement may warrant separate presentation in the notes to the financial statements.



### 1.2.5 Offsetting

Assets and liabilities in the statement of financial position and income and expenses in the statement of profit or loss and other comprehensive income should not be offset unless required or permitted by an SLFRS.

### 1.2.6 Frequency of reporting

A complete set of financial statements should be presented at least annually. If an entity changes its reporting date and prepares financial statements for a period longer or shorter than one year, the entity should disclose:

- The period covered by the financial statements
- The reason for using a longer or shorter period
- The fact that amounts presented in the financial statements are not entirely comparable

### 1.2.7 Comparative information

Comparative information should be presented in respect of the preceding period for all amounts reported in the current period's financial statements unless an accounting standard permits or requires otherwise.

Therefore, as a minimum, two statements of financial position, two statements of profit or loss and other comprehensive income, two statements of cash flows, two statements of changes in equity and two sets of related notes.

A third statement of financial position must also be presented at the beginning of the comparative period when:

- (a) An accounting policy is applied retrospectively or other retrospective restatement is made
- (b) This has a material effect on the information in the statement of financial position at the start of the comparative period

### 1.2.8 Consistency of presentation

Presentation and classification of items in the financial statements should be consistent from one period to the next unless a new SLFRS requires a change in presentation, or another presentation or classification would be more appropriate following a significant change in the nature of the entity's operations or a review of its financial statements.

## 2 The statement of financial position



**LKAS 1 provides a suggested format for a statement of financial position together with guidance on the current/non-current distinction.**

### 2.1 Format of statement of financial position

LKAS 1 provides the following suggested format for a statement of financial position.

ABC CO

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X2

	20X2		20X1	
	Rs'000	Rs'000	Rs'000	Rs'000
<i>Assets</i>				
Non-current assets:				
Property, plant and equipment	X		X	
Goodwill	X		X	
Other intangible assets	<u>X</u>		<u>X</u>	
		X		X
Current assets:				
Inventories	X		X	
Trade receivables	X		X	
Other current assets	X		X	
Cash and cash equivalents	<u>X</u>		<u>X</u>	
		<u>X</u>		<u>X</u>
<i>Total assets</i>		<u>X</u>		<u>X</u>
<i>Equity and liabilities</i>				
Equity:				
Stated capital	X		X	
Retained earnings	X		X	
Other components of equity	<u>X</u>		<u>X</u>	
		X		X
Non-current liabilities:				
Long-term borrowings	X		X	
Long-term provisions	<u>X</u>		<u>X</u>	
		X		X

	20X2		20X1	
	Rs'000	Rs'000	Rs'000	Rs'000
Current liabilities:				
Trade and other payables	X		X	
Short-term borrowings	X		X	
Current portion of long-term borrowings	X		X	
Current tax payable	X		X	
Short-term provisions	<u>X</u>		<u>X</u>	
		<u>X</u>		<u>X</u>
<i>Total equity and liabilities</i>		<u><u>X</u></u>		<u><u>X</u></u>

## 2.2 Minimum disclosure

As a minimum, a statement of financial position should include the following line items (where relevant).

- (a) Property, plant and equipment (Chapter 5)
- (b) Investment property (Chapter 6)
- (c) Intangible assets (Chapter 7)
- (d) Financial assets (other than those in (e), (h) and (i)) (Chapter 14)
- (e) Investments accounted for using the equity method (Chapter 24)
- (f) Biological assets (Chapter 10)
- (g) Inventories (Chapter 10)
- (h) Trade and other receivables
- (i) Cash and cash equivalents
- (j) The total of assets classified as held for sale and assets included in disposal groups classified as held for sale under SLFRS 5 (Chapter 17)
- (k) Trade and other payables
- (l) Provisions (Chapter 11)
- (m) Financial liabilities (other than amounts under (k) and (l)) (Chapter 14)
- (n) Liabilities and assets for current tax (Chapter 13)
- (o) Deferred tax liabilities and deferred tax assets (Chapter 13)
- (p) Liabilities included in disposal groups classified as held for sale in accordance with SLFRS 5 (Chapter 17)
- (q) Non-controlling interests presented within equity (Chapter 22)
- (r) Issued capital and reserves

## 2.3 The current/non-current distinction

Current and non-current assets and liabilities should be presented separately in the statement of financial position other than where a presentation based on liquidity provides more relevant and reliable information. In this case, all assets and liabilities are presented broadly in order of liquidity.

An asset should be classified as a **current asset** when it is:

- (a) Expected to be realised in, or is held for sale or consumption in, the normal operating cycle of the entity
- (b) Held primarily for the purpose of being traded
- (c) Expected to be realised within 12 months after the reporting date
- (d) Cash or a cash equivalent which is not restricted in its use

All other assets should be classified as non-current assets.

A liability should be classified as a **current liability** when it is:

- (a) Expected to be settled in the normal operating cycle of the entity
- (b) Due to be settled within 12 months of the reporting date
- (c) Held primarily for the purpose of being traded

All other liabilities should be classified as non-current liabilities.



### QUESTION

### The current/non-current distinction

The following issues have come to light in the preparation of the financial statements for BCA Plantations PLC in the year ended 31 December 20X3:

- (1) During the year, the company breached a condition of a long-term loan agreement with its bank, meaning that the loan became payable on demand. Despite this, the bank agreed in January 20X4 (before the 20X3 financial statements were authorised for issue) not to demand payment as a consequence of the breach.
- (2) The company has also taken a loan from another finance provider. This was due for repayment on 31 August 20X5; however BCA Plantations negotiated a refinancing deal with the counterparty in January 20X4 (before the 20X3 financial statements were authorised for issue) meaning that the loan term is extended to 20X7.

### Required

In each case, **advise** whether the liability is current or non-current.

## ANSWER

- (1) BCA Plantations has breached a condition of the loan agreement, so making it repayable on demand. Therefore, at 31 December 20X4, the loan is classified as current. The fact that the bank has subsequently agreed not to demand payment does not alter this classification.
- (2) At the reporting date, the liability is classified as current. The subsequent refinancing agreement does not affect this classification.

## 3 The statement of profit or loss and other comprehensive income



**LKAS 1 specifies the format and minimum disclosure requirements for the statement of profit or loss and other comprehensive income.**

### 3.1 Format of the statement of profit or loss and other comprehensive income

LKAS 1 requires entities to include a **statement of profit or loss and other comprehensive income**, either as a single statement or as two separate statements: a statement of profit or loss and a statement of other comprehensive income. This statement reports total comprehensive income.



**Total comprehensive income** is the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners.

LKAS 1 gives the following suggested format for a statement of profit or loss and other comprehensive income.

ABC CO

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR  
THE YEAR ENDED 31 DECEMBER 20X2*Illustrating the classification of expenses by function*

	20X2	20X1
	Rs '000	Rs '000
Revenue	X	X
Cost of sales	<u>(X)</u>	<u>(X)</u>
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance cost	<u>(X)</u>	<u>(X)</u>
<i>Profit before tax</i>	X	X
Income tax expense	<u>(X)</u>	<u>(X)</u>
<i>Profit for the year</i>	X	X
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	<u>X</u>	<u>X</u>
<i>Total comprehensive income for the year</i>	<u>X</u>	<u>X</u>

**3.2 Minimum disclosure**

As a minimum, LKAS 1 requires the following items to be disclosed on the face of the statement of profit or loss and other comprehensive income:

- (a) Revenue (Chapter 12)
- (b) Finance costs
- (c) Share of profits and losses of associates and joint ventures accounted for using the equity method (Chapter 24)
- (d) Tax expense (Chapter 13)
- (e) A single amount comprising the total of:
  - (i) The post-tax profit or loss of discontinued operations
  - (ii) The post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation (Chapter 17)
- (f) Profit or loss
- (g) Each component of other comprehensive income classified by nature

- (h) Share of the other comprehensive income of associates and joint ventures
- (i) Total comprehensive income

LKAS 1 also requires that any other line items, headings or sub-totals should be shown in the statement of profit or loss and other comprehensive income when it is necessary for an understanding of the financial position of the entity or if another SLFRS requires it.

Management must decide whether to present additional items separately. They should consider factors including materiality and the nature and function of the items of income and expense when making this decision.

### 3.3 Other comprehensive income



**Other comprehensive income** comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other SLFRSs.

Components of other comprehensive income within the KB1 syllabus include:

- (a) Changes in the revaluation surplus (Chapters 5 and 7)
- (b) Actuarial gains and losses on defined benefit plans recognised in accordance with LKAS 19 *Employee benefits* (Chapter 15)
- (c) Gains and losses on re-measuring available-for-sale financial assets in accordance with LKAS 39 (Chapter 14)

#### 3.3.1 Presentation of other comprehensive income

Items of other comprehensive income should be classified in the statement of profit or loss and other comprehensive income into those that may be reclassified to profit or loss in accordance with another standard and those that will not be reclassified to profit or loss.

Other comprehensive income items are presented either of the following.

- Net of related tax effects
- Before related tax effects, with one amount shown for the aggregate amount of income tax relating to those items

Where the second approach is adopted, the amount of tax should be allocated between those items that may be reclassified subsequently to profit or loss and those that will not.

Reclassification adjustments relating to components of other comprehensive income should be disclosed either in the statement of profit or loss and other comprehensive income or in the notes to the accounts. These are amounts reclassified to profit or loss in the current period that were recognised in other comprehensive income in previous periods. Users can use this information to assess the impact of reclassifications on profit or loss.

## 4 The statement of changes in equity and notes



The statement of changes in equity shows the movements in an entity's equity for the period.

The statement of changes in equity links financial performance (profit and other comprehensive income) with the results of transactions with owners of the business, such as share issues and dividends. It reconciles the opening balance for each element of equity with the closing balance.

The following should be disclosed.

- (a) Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to the non-controlling interests.
- (b) For each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with LKAS 8
- (c) For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from:
  - (i) Profit or loss
  - (ii) Other comprehensive income
  - (iii) Transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners, and changes in ownership interests in subsidiaries that do not result in a loss of control



## 4.1 Format of a statement in changes in equity

An example statement of changes in equity is shown below.

ABC CO

### STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X2

	<i>Stated capital</i>	<i>Revaluation surplus</i>	<i>Retained earnings</i>	<i>Total</i>
<i>Balance at 1.1.X2</i>	X	X	X	X
Changes in accounting policy	-	-	(X)	(X)
Restated balance	X	X	X	X
<i>Changes in equity for 20X2</i>				
Dividends	-	-	(X)	(X)
Total comprehensive income or the year	-	X	X	X
Issue of stated capital	<u>X</u>	-	-	<u>X</u>
<i>Balance at 31.12.X2</i>	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>

**Dividends paid** during the year are not shown on the statement of profit or loss; they are shown in the statement of changes in equity.

## 4.2 Dividends

Dividends are recognised in the statement of changes in equity when they are declared by directors, not when they are proposed. It is only at this stage that an obligation arises to pay the dividend.

In some cases, dividends are not payable in cash. In this case, IFRIC 17 *Distributions of non-cash assets to owners* applies.

This states that:

- A dividend payable is recognised only when the dividend is authorised and no longer at the discretion of the management.
- The dividend is measured at the fair value of the net assets to be distributed.
- The liability is re-measured at each reporting date and settlement, with changes recognised directly in equity.
- The difference between the dividend paid and the carrying amount of the net assets distributed is recognised in profit or loss and disclosed separately.
- Addition disclosures are required if the net assets held for distribution meet the definition of a discontinued operation.

## 5 LKAS 8 *Accounting policies, changes in accounting estimates and errors*



A change in accounting policy or correction of error is dealt with retrospectively so that the financial statements appear as if the new policy had always been in place or the error had never occurred; a change in accounting estimate is dealt with prospectively.

This section of the chapter is revision of KE1 material.

### 5.1 Definitions

The following definitions are provided in LKAS 8.



**Accounting policies** are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

A **change in accounting estimate** is an adjustment of the carrying amount of an asset or a liability or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

**Material.** Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements.

**Prior period errors** are omissions from, and misstatements in, the financial statements for one or more prior periods arising from a failure to use, or a misuse of, reliable information that:

- (a) Was available when financial statements for those periods were authorised for issue
- (b) Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

**Retrospective application** is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

**Retrospective restatement** is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

**Prospective application** of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:

- (a) Applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed
- (b) Recognising the effect of the change in the accounting estimate in the current and future periods affected by the change

**Impracticable.** Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. It is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if one of the following applies.

- (a) The effects of the retrospective application or retrospective restatement are not determinable.
  - (b) The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period.
  - (c) The retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that: provides evidence of circumstances that existed on the date(s) at which those amounts are to be recognised, measured or disclosed; and would have been available when the financial statements for that prior period were authorised for issue, from other information.
-

## 5.2 Accounting policies

LKAS 8 deals with the selection of accounting policies and accounting for changes in accounting policies. The following summarises KE1 assumed knowledge.

<b>Selection</b>	<ul style="list-style-type: none"> <li>• Apply relevant Sri Lanka accounting standard/CASL guidance.</li> <li>• In the absence of these, management use judgement to select a policy and should refer to SLFRS/interpretations dealing with similar issues, the Conceptual Framework and pronouncements of other standard setters.</li> <li>• Policies must be selected consistently for similar transactions/category of items in accordance with SLFRS.</li> </ul>
<b>Accounting for changes</b>	<ul style="list-style-type: none"> <li>• Only change policy if required by an SLFRS or for more relevant and reliable presentation.</li> <li>• Where a new SLFRS is adopted, the transitional provisions of the new standard detail the required accounting treatment for the change in policy.</li> <li>• A change from applying the cost model to the revaluation model of LKAS 16 is accounted for in accordance with LKAS 16 rather than LKAS 8 (see Chapter 5).</li> <li>• Otherwise a change in policy is applied retrospectively, ie as if the new policy had always been in place.</li> </ul>
<b>Disclosure</b>	<ul style="list-style-type: none"> <li>• When a change in accounting policy has a material effect on the current period or any prior period presented, or may have a material effect in subsequent periods, disclose:               <ol style="list-style-type: none"> <li>(a) Reasons for the change/nature of change</li> <li>(b) Amount of the adjustment for the current period and for each period presented</li> <li>(c) Amount of the adjustment relating to periods prior to those included in the comparative information</li> <li>(d) The fact that comparative information has been restated or that it is impracticable to do so</li> </ol> </li> <li>• Disclose information relevant to assessing the impact of new SLFRSs on the financial statements, where these have not yet come into force.</li> </ul>



## QUESTION

## Accounting policies

An accounting standard provides a choice of measuring a particular type of asset at either historical cost or fair value (which must be kept up to date). The chosen accounting policy must be applied consistently to all assets within the scope of the relevant standard.

### Required

**Discuss** what a company's management should consider when choosing which policy to adopt.

## ANSWER

The company's management may choose either policy and remain in accordance with SLFRS. Therefore, other considerations may include:

- (1) Application of the conceptual framework – the qualitative characteristics should be considered; in particular, fair value measurement tends to result in more relevant information.
- (2) Measurement of other assets – if other assets are measured at fair value, then adoption of the fair value model in this case would result in comparable measurement bases of items in the statement of financial position, so making it more understandable and relevant.
- (3) Impact on position – where fair values tend to increase (eg properties), the impact on the statement of financial position is generally beneficial, as net assets are increased. This may attract investors and help the company to secure finance. The fair value of the asset type in question may, however, decrease, in which case the opposite effect may be felt. It should also be remembered that the fair value of some of the asset class may increase and some may decrease, hence any benefit may be negligible.
- (4) Impact on performance – depending on the requirements of the standard, changes in fair value may be recognised in profit or loss. If fair values change frequently, this could result in volatile profits, which may deter investors.
- (5) Practical aspects – if the company chooses to apply a fair value model, the onus is on it to keep fair value up to date. This may be costly and involve paying for expert opinion. Since the policy must be applied to all similar assets, the cost may be significant. In addition, adoption of this policy will cause extra work for internal departments who must deal with the administrative side of a fair value exercise.

### 5.3 Changes in accounting estimates

The following summarises assumed knowledge from KE1 in respect of accounting estimates.

<b>Estimates</b>	<ul style="list-style-type: none"> <li>Estimates are areas where judgement is required in order to apply an accounting policy, eg useful lives and irrecoverable debt allowance.</li> </ul>
<b>Accounting for changes</b>	<ul style="list-style-type: none"> <li>Changes are dealt with prospectively.</li> <li>Therefore, they affect the current period and may also affect future periods, however prior years' financial statements are not restated.</li> <li>The effect of a change in accounting estimate is included in the same expense classification as was used for the previous estimate.</li> </ul>
<b>Disclosure</b>	<ul style="list-style-type: none"> <li>The nature and amount of a change in an accounting estimate that has a material effect in the current period (or which is expected to have a material effect in subsequent periods) should be disclosed.</li> <li>If it is not possible to quantify the amount, this impracticability should be disclosed.</li> </ul>



#### QUESTION

#### Changes in accounting estimates

Wijekoon Flooring (Pvt) Ltd acquired a delivery van on 1 January 20X5 at a cost of Rs. 80,000. At that date, it was estimated that the van had a useful life of five years and a residual value of Rs. 10,000. At 31 December 20X7, these estimates are revised to a total useful life of seven years and a residual value of nil.

#### Required

**Calculate** the amounts recognised in profit or loss for each of the years ended 31 December 20X5, 20X6, 20X7 and 20X8 in respect of the van's depreciation.

#### ANSWER

In each of the years ended 31 December 20X5, 20X6 and 20X7, the amount recognised for depreciation is:

$$(\text{Rs. } 80,000 - \text{Rs. } 10,000) / 5 \text{ years} = \text{Rs. } 14,000$$

In the year ended 31 December 20X8, the depreciation expense is:

$$(\text{Rs. } 80,000 - (\text{Rs. } 14,000 \times 3)) / 4 \text{ years} = \text{Rs. } 9,500$$

## 5.4 Errors

The following summarises assumed knowledge from KE1 in respect of errors.

<b>Errors</b>	<ul style="list-style-type: none"> <li>Errors may arise through mathematical mistakes, misinterpretation, oversights, fraud or mistakes in the application of accounting policies.</li> </ul>
<b>Accounting for errors</b>	<ul style="list-style-type: none"> <li>Errors arising in the current period are dealt with through profit or loss.</li> <li>Material prior period errors are corrected retrospectively by restating comparative amounts and, where relevant, restating opening balances of the earliest comparative period.</li> <li>The effect of this is to present the financial statements as if the error had never occurred.</li> <li>Where this is impracticable, the error is corrected prospectively.</li> </ul>
<b>Disclosure</b>	<ul style="list-style-type: none"> <li>Nature of the prior period error.</li> <li>For each prior period, to the extent practicable, the amount of the correction.               <ul style="list-style-type: none"> <li>(i) For each financial statement line item affected</li> <li>(ii) If LKAS 33 applies, for basic and diluted earnings per share</li> </ul> </li> <li>The amount of the correction at the beginning of the earliest prior period presented.</li> <li>If retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected. Subsequent periods need not repeat these disclosures.</li> </ul>



### QUESTION

### Correction of errors

The financial accountant of Dias Construction Co realises at 31 December 20X4 that the company has been measuring inventory using the last in, first out (LIFO) method, disallowed by LKAS 2. Inventory in the draft financial statements is:

	<i>31.12.X4</i>	<i>31.12.X3</i>
Inventory	Rs. 540,000	Rs. 510,000

Under the first in, first out (FIFO) method, the inventory balance at these dates would be Rs. 561,000 at the 20X4 year end and Rs. 522,000 at the 20X3 year end.

At the 20X2 year end, inventory would have been Rs. 10,000 higher than as reported; prior to this, the difference between LIFO and FIFO valuations of inventory would have been negligible.

### Required

**Explain** how this should be accounted for in the financial statements of Dias Construction for the year ended 31 December 20X4.

### ANSWER

- (a) The change from LIFO to FIFO in order to conform to LKAS 2 is both a change in accounting policy and the correction of an error; it should therefore be accounted for retrospectively (as if FIFO had always been applied).
- (b) The inventory balance is reported as Rs. 561,000 at 31.12.X4 and the comparative figure is reported as Rs. 522,000.
- (c) In the statement of profit or loss, cost of sales in 20X4 is adjusted as follows:
  - Opening inventory increases by Rs. 12,000 (Rs. 522,000 – Rs. 510,000)
  - Closing inventory increases by Rs. 21,000 (Rs. 561,000 – Rs. 540,000)
  - There is a net decrease of cost of sales of Rs. 9,000
- (d) In the statement of profit or loss, cost of sales in 20X3 is adjusted as follows:
  - Opening inventory increases by Rs. 10,000
  - Closing inventory increases by Rs. 12,000
  - There is a net decrease of cost of sales of Rs. 2,000
- (e) Retained earnings brought forward at 1 January 20X3 are subject to a prior period adjustment to reflect the Rs. 10,000 increase in inventory as reported at 31 December 20X2.

## 6 Foreign currency transactions



**A company records a foreign currency transaction at the spot exchange rate on the date of the transaction. Subsequent retranslation of the 'foreign' balance in the statement of financial position results in exchange gains or losses.**

### 6.1 Introduction

Most companies engage in some overseas trade, buying or selling assets in foreign currencies. For example, a Sri Lankan company might buy materials from India,



and pay for them in Indian rupees, and then sell its finished goods in Singapore, receiving payment in dollars, or perhaps in some other currency. The Sri Lankan company will probably keep its accounting records (and publish its financial statements) in rupees, and therefore it must translate purchases and sales transactions denominated in other currencies into rupees before accounting for them.

If foreign currency exchange rates remained constant, there would be no further accounting problem. As you will be aware, however, foreign exchange rates are continually changing. Therefore where 'foreign currency' balances remain in the statement of financial position at the year end, these may need retranslating using up-to-date exchange rates.

## 6.2 LKAS 21 *The effects of changes in foreign exchange rates*

LKAS 21 addresses two accounting issues arising from foreign exchange rates:

- (1) The situation detailed above whereby a company transacts in foreign currency.
- (2) The situation where one company owns a foreign company and has to incorporate its results in the group financial statements.

The first of these scenarios is dealt with in this chapter; the second is a KC1 topic and is not covered at KB1 level.

### 6.2.1 Definitions

LKAS 21 includes the following definitions.



A **foreign currency** is a currency other than the functional currency of the entity.

The **functional currency** is the currency of the primary economic environment in which the entity operates.

The **presentation currency** is the currency in which the financial statements are presented.

An **exchange difference** is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

The **closing rate** is the spot exchange rate at the year-end date.

The **spot exchange rate** is the exchange rate for immediate delivery.

**Monetary items** are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

### 6.2.2 Functional currency and presentation currency

Each entity should determine its **functional currency** and measure its results and financial position in that currency. The functional currency is the currency of the primary economic environment in which the entity operates.

For most individual entities, the functional currency will be the currency of the country in which they are located and in which they carry out most of their transactions.

An entity can present its financial statements in any currency it chooses. This is the **presentation currency**. For most individual entities, the presentation currency is the same as the functional currency.

## 6.3 Foreign currency transactions

### 6.3.1 Initial recognition

LKAS 21 states that a foreign currency transaction should be recorded, on initial recognition in the functional currency, by applying the exchange rate between the reporting currency and the foreign currency **at the date of the transaction** to the foreign currency amount. This is known as the 'spot rate'.

An **average rate** for a period may be used if exchange rates do not fluctuate significantly.

### 6.3.2 Settlement before reporting date

Where a foreign currency transaction has taken place, resulting in a receivable or payable and the amount is settled before the reporting date, the following procedure applies.

- (1) The amount paid/received is translated using the spot rate at the settlement date and recorded as a cash transaction.
- (2) The receivable/payable is derecognised at the amount at which it was recognised.
- (3) Any difference is recognised as profit or loss.



### 6.3.3 Example: foreign currency transaction

A Sri Lankan company sells goods to a Chinese company in June 20X4, and agrees to invoice in Chinese yuan. The price is Y116,000 and the exchange rate at the time of sale is Y1 to Rs. 20, but when the debt is eventually paid in July 20X4, the rate has altered to Y1 to Rs. 19.5. The Sri Lankan company has a 31 December year end.

The company records the sale as follows.

DEBIT	Trade receivables (116,000 × 20)	Rs. 2,320,000
CREDIT	Sales revenue	Rs. 2,320,000

When the Y116,000 is received, the Sri Lankan company converts it into Rs, to obtain (× 19.5) Rs. 2,262,000. The difference between this cash receipt and the trade receivable which is extinguished (Rs. 2,320,000) is an exchange gain on settlement of Rs. 58,000 which is recognised in profit or loss:

DEBIT	Cash	Rs. 2,262,000
CREDIT	Trade receivables	Rs. 2,320,000
CREDIT	Exchange gain	Rs. 58,000

### 6.3.4 Settlement after reporting date

Where settlement takes place in a different accounting period from the initial foreign currency transaction, there are 'foreign' assets or liabilities in the year-end statement of financial position.

The following rules apply to this scenario.

- (a) Foreign currency monetary items (eg loans, receivables and payables) are retranslated using the closing rate
- (b) Non-monetary items (eg non-current assets and inventories) which are carried at historical cost are not retranslated, ie they remain in the financial statements translated at the rate that applied when they were purchased (historical rate)
- (c) Non-monetary items which are carried at fair value are translated using the exchange rates that existed when the values were measured



### 6.3.5 Example: retranslation at year end

TG Imports (Pvt) Ltd has bought goods from Australia, priced in Australian dollars, for many years. On 18 November 20X3, the company buys goods for \$80,000, receiving three months' credit from the supplier. TG Imports paid the supplier on 12 February 20X4. TG Imports has a 31 December year end, and the goods remained in stock at this date.

Relevant exchange rates are:

18 November 20X3	\$1:Rs. 116
31 December 20X3	\$1:Rs. 120
12 February 20X4	\$1:Rs. 119

20X3

The transaction is initially recorded by:

DEBIT	Purchases ( $80,000 \times 116$ )	Rs. 9,280,000	
CREDIT	Trade payables		Rs. 9,280,000

At the reporting date, there are two 'foreign' items in the statement of financial position: the payable and the unsold inventory. The payable is a monetary item and must be retranslated; the inventory is a non-monetary item and is not retranslated. The retranslation of the payable is recognised by:

DEBIT	Exchange loss ( $(80,000 \times 120) - 9,280,000$ )	Rs. 320,000	
CREDIT	Trade payables		Rs. 320,000

Therefore in the 20X3 financial statements:

- The balance due to the Australian supplier is Rs. 9,600,000
- Inventory acquired from the Australian supplier is Rs. 9,280,000
- There is an exchange loss in the statement of profit or loss of Rs. 320,000

20X4

At settlement, the cash payment is recorded, payable derecognised and exchange difference recognised by:

DEBIT	Trade payables	Rs. 9,600,000	
CREDIT	Cash ( $80,000 \times 119$ )		Rs. 9,520,000
CREDIT	Exchange gain		Rs. 80,000

Therefore, in the 20X4 financial statements there is an exchange gain in the statement of profit or loss of Rs. 80,000.

### 6.3.6 Exchange differences

As we have seen, exchange differences occur in relation to monetary items when there is a change in the exchange rate between the transaction date and the reporting date or between the transaction date and the settlement date.

Exchange differences arising on the settlement or retranslation of monetary items are recognised in profit or loss in the period in which they arise.

When a gain or loss on a non-monetary item is recognised in other comprehensive income (for example, where property is revalued), any related exchange differences should also be recognised in other comprehensive income.

**QUESTION****Foreign exchange transaction**

SLA Imports, whose year end is 31 December, buys some goods from Rinka SA of France on 30 September. The invoice value is €40,000 and is due for settlement in equal instalments on 30 November and 31 January. The exchange rate moved as follows.

	€1 = Rs.
30 September	170
30 November	180
31 December	178
31 January	183

**Required**

**State** the accounting entries in the books of SLA Imports.

**ANSWER**

The purchase will be recorded in the books of SLA Imports using the spot rate of exchange on 30 September.

DEBIT	Purchases	Rs. 6,800,000	
CREDIT	Trade payables		Rs. 6,800,000

Being the Rs. cost of goods purchased for €40,000 ( $€40,000 \times 170$ ).

On 30 November, SLA Imports must pay €20,000. This will cost  $€20,000 \times 180 =$  Rs. 3.6m and the company has therefore made an exchange loss of Rs. 2.6m – Rs. 3.4m – Rs. 0.2m.

DEBIT	Trade payables	Rs. 3,400,000	
DEBIT	Exchange loss (SPL)	Rs. 200,000	
CREDIT	Cash		Rs. 3,600,000

On 31 December, the year end, the outstanding liability will be recalculated using the rate applicable to that date:  $€20,000 \times 178 =$  Rs. 3.56m. A further exchange loss of Rs. 3.56m – Rs. 3.4m = Rs. 160,000 has been made and will be recorded as follows.

DEBIT	Exchange loss (SPL)	Rs. 160,000	
CREDIT	Trade payables		Rs. 160,000

The total exchange loss of Rs. 360,000 will be included in the operating profit for the year ending 31 December.

On 31 January, SLA Imports must pay the second instalment of €20,000. This will cost them Rs. 3,660,000 ( $€20,000 \times 183$ ).

DEBIT	Trade payables	Rs. 3,560,000	
	Exchange loss (SPL)	Rs. 100,000	
CREDIT	Cash		Rs. 3,660,000

## 7 Interim financial statements



**LKAS 34 recommends that entities should produce interim financial reports, and for entities that do publish such reports, it lays down principles and guidelines for their production.**

Some entities, particularly larger companies and those listed on a stock exchange, choose to, or are required to, present interim financial statements as well as annual (year-end) financial statements.

LKAS 34 does not prescribe whether an entity should present interim statements, nor how often. It does, however, provide guidance on contents for those entities that do present interim statements.

In the case of publicly traded companies, LKAS 34 encourages:

- Interim financial reports to be prepared at least at the end of the first half of the financial year
- Interim financial reports to be made available not later than 60 days after the end of the interim period

### 7.1 Definitions

LKAS 34 provides the following definitions.



An **interim period** is a financial reporting period shorter than a full financial year.

An **interim financial report** is a financial report containing either a complete set of financial statements (as described in LKAS 1) or set of condensed financial statements (as described in LKAS 34) for an interim period.

### 7.2 Minimum components

The minimum components of an interim financial report are as follows:

- A condensed statement of financial position

- A condensed statement of profit or loss and other comprehensive income
- A condensed statement of changes in equity
- A condensed statement of cash flows
- Selected explanatory notes

The condensed financial statements should include, as a minimum, each of the headings and subtotals that were included in its most recent annual financial statements.

Rather than present condensed financial statements in the interim report, an entity may choose to present a complete set of financial statements in its interim financial report. In that case, the form and content of the financial statements should conform to the requirements of LKAS 1.

### 7.3 Periods covered

The standard requires that interim financial reports should provide financial information for the following periods or as at the following dates.

- Statement of financial position data** as at the end of the current interim period, and comparative data as at the end of the most recent financial year.
- Statement of profit or loss and other comprehensive income data** for the current interim period and cumulative data for the current year to date, together with comparative data for the corresponding interim period and cumulative figures for the previous financial year.
- Statement of cash flows data** should be **cumulative** for the current year to date, with comparative cumulative data for the corresponding interim period in the previous financial year.
- Data for the statement of changes in equity** should be for both the current interim period and for the year to date, together with comparative data for the corresponding interim period, and cumulative figures, for the previous financial year.

### 7.4 Materiality in interim financial statements

LKAS 34 states that when deciding how to recognise, measure, classify or disclose an item for interim financial reporting purposes, an entity should assess materiality in relation to the interim period financial data.

The assessment of materiality should also recognise that interim measurements may rely on estimates to a greater extent than annual measurements.

### **7.5 IFRIC 10 *Interim reporting and impairment***

IFRIC 10 addresses a conflict between the requirements of LKAS 34 and those in other standards on the recognition and reversal of impairment losses.

IFRIC 10 concludes that an impairment loss recognised in a previous interim period in respect of goodwill or an investment in an equity instrument or financial asset carried at cost may not be reversed.





## CHAPTER ROUNDUP

- ↳ LKAS 1 states that a complete set of financial statements includes a statement of financial position, a statement of profit or loss and other comprehensive income, a statement of changes in equity, a statement of cash flows and disclosures notes.
- ↳ **LKAS 1 provides a suggested format for a statement of financial position together with guidance on the current/non-current distinction.**
- ↳ **LKAS 1 specifies the format and minimum disclosure requirements for the statement of profit or loss and other comprehensive income.**
- ↳ The statement of changes in equity shows the movements in an entity's equity for the period.
- ↳ **A change in accounting policy or correction of error is dealt with retrospectively so that the financial statements appear as if the new policy had always been in place or the error had never occurred; a change in accounting estimate is dealt with prospectively.**
- ↳ **A company records a foreign currency transaction at the spot exchange rate on the date of the transaction. Subsequent retranslation of the 'foreign' balance in the statement of financial position results in exchange gains or losses.**
- ↳ **LKAS 34 recommends that entities should produce interim financial reports, and for entities that do publish such reports, it lays down principles and guidelines for their production.**


**PROGRESS TEST**

- 1 When is a third statement of financial position required?
- 2 What is a reclassification adjustment?
- 3 When is a change in accounting policy permitted?
- 4 What is functional currency?
- 5 What is a monetary item?
- 6 Is it a requirement of LKAS 34 that interim reports contain condensed financial statements?
- 7 Which of the following is/are a current asset in the financial statements of a shipbuilding company?
  - 1 A ship under construction, which will take a further estimated 600 days to complete
  - 2 An amount lent to a supplier with a repayment date in two years' time
  - A 1 only
  - B 2 only
  - C 1 and 2
  - D Neither of them
- 8 Which of the following is/are a change in accounting policy?
  - 1 A move from the LKAS 16 cost model to the LKAS 16 revaluation model
  - 2 Reclassifying certain expenses as administrative expenses rather than cost of sales
  - A 1 only
  - B 2 only
  - C 1 and 2
  - D Neither of them
- 9 A Sri Lankan company purchased \$10,000 worth of goods from an American company in October 20X5. On the date of purchase, the exchange rate was \$1:Rs. 125. Half of the amount owed was settled in mid-December, when the exchange rate was \$1:Rs. 127 and the other half in January, when the exchange rate was \$1:Rs. 130. At the year end 30 November 20X5, the exchange rate was \$1:Rs. 128.  
 What exchange rate difference is reported in profit or loss in the year ended 30 November 20X6?
  - A Rs. 35,000 loss
  - B Rs. 5,000 loss
  - C Rs. 25,000 loss
  - D Rs. 30,000 loss

## ANSWERS TO PROGRESS TEST

- 1 When retrospective adjustment has been made that affects the statement of financial position at the start of the comparative period.
- 2 An amount reclassified to profit or loss in the current period that was recognised in other comprehensive income in the current or previous periods.
- 3 When required by an SLFRS or when it results in more reliable and relevant presentation.
- 4 It is the currency of the primary economic environment in which the entity operates.
- 5 A monetary item is cash or an item in the statement of financial position that will be settled in cash, eg receivables, payables and loans.
- 6 No, interim reports may contain a full statement of financial position presented in accordance with LKAS 1.
- 7 The answer is **A**. The ship is inventory that will be sold in the normal operating cycle of the company and this is therefore a current asset; the loan is not due within 12 months, is not held for trading and is not part of the company's normal operating cycle, therefore it is non-current.
- 8 The answer is **C**. A change in accounting policy occurs where there is a change in recognition, measurement or presentation.
- 9 The answer is **B**. At 30 November 20X5, the payable balance is reported in the statement of financial position at Rs. 1,280,000 ( $10,000 \times 128$ ).

Amounts paid in the year ended 30 November 20X6 to settle the amount due are:

December ( $5,000 \times 127$ )	=	Rs. 635,000
January ( $5,000 \times 130$ )	=	<u>Rs. 650,000</u>
		Rs. 1,285,000

Therefore, Rs. 5,000 more is paid to settle the payable than the balance previously reported and this is the loss recognised in the year ended 30 November 20X6.



# Part B - Financial reporting standards: recognition and measurement



# Property, Plant and Equipment

## INTRODUCTION

Property, plant and equipment (PPE) is often one of the largest numbers in a statement of financial position. You must know when to recognise an item of PPE and how to measure it.

The material in this chapter is largely revision of KE1 material.

Knowledge Component			
<b>2</b>	<b>Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)</b>		
<b>2.1</b>	<b>Level A</b>	<b>2.1.1</b>	Advise on the application of Sri Lanka Accounting Standards in solving complicated matters.
		<b>2.1.2</b>	Recommend the appropriate accounting treatment to be used in complicated circumstances in conformity with Sri Lanka Accounting Standards.
		<b>2.1.3</b>	Evaluate the impact of application of different accounting treatments.
		<b>2.1.4</b>	Propose appropriate accounting policies to be selected in different circumstances.

Knowledge Component		
2.2 <b>Level B</b>	2.1.5	Evaluate the impact of use of different expert inputs to financial reporting.
	2.1.6	Advise on the appropriate application and selection of accounting/reporting options given under standards.
	2.1.7	Design the appropriate disclosures to be made in the financial statements.
	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
	2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
	2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
	2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
	2.2.5	Outline the disclosures to be made in the financial statements.



CHAPTER CONTENTS	LEARNING OUTCOME
1 Introduction and definitions	2.1
2 Recognition and initial measurement	2.1
3 Depreciation	2.1
4 Revaluation	2.1
5 Disposals	2.1
6 Disclosure	2.1

## LKAS 16 Learning objectives

- Identify the criteria that must be satisfied in order to recognise an item as an asset.
- Explain the components of the cost of an asset.
- Explain the accounting treatment for initial measurement and subsequent measurement of property, plant and equipment (PPE).
- Apply the methodology to compute the cost of an asset.
- Explain the adjustment for revaluation.
- Record the revaluation surplus/deficit arising on revaluation of PPE.
- Assess impairment indicators and impairment of PPE.
- Apply the methodology given in LKAS 16 to assessment and reassessment of useful life, residual value and depreciation for a given scenario.
- Compute the depreciation and impairment loss of PPE.
- Outline the disclosures to be made in respect of PPE.

## LKAS 23 Learning objectives

- Describe borrowing cost and qualifying assets.
- Explain the conditions to be satisfied to capitalise borrowing cost.
- Explain commencement, suspension and cessation of capitalisation.
- Compute the borrowing costs that need to be capitalised.
- Explain the disclosure requirements pertaining to borrowing costs.

## 1 Introduction and definitions



**LKAS 16 *Property, plant and equipment* provides guidance on recognising and measuring non-current assets. These usually form the largest balance in the statement of financial position.**

### 1.1 Scope

LKAS 16 applies to all property, plant and equipment (PPE) with the following exceptions:

- PPE classified as held for sale (see Chapter 17 – SLFRS 5)
- Biological assets related to agricultural activity (see Chapter 10 – LKAS 41)

### 1.2 Definitions

The following definitions are provided in LKAS 16.



**Property, plant and equipment** are tangible assets that:

- Are held by an entity for **use** in the production or supply of goods or services, for rental to others, or for administrative purposes
- Are expected to be **used during more than one period**

**Cost** is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

**Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Carrying amount** is the amount at which an asset is recognised after deducting any accumulated depreciation and impairment losses. (LKAS 16)

## 2 Recognition and initial measurement



**The recognition criteria of LKAS 16 are the same as those in the Conceptual Framework. An item of PPE is initially measured at cost.**

## 2.1 Recognition

An item of PPE is recognised when:

- (a) It is probable that future economic benefits associated with the asset will flow to the entity
- (b) The cost of the asset to the entity can be measured reliably

Individually insignificant assets such as tools and moulds may be aggregated for recognition as PPE.

### 2.1.1 Health and safety and environmental equipment

Certain health and safety and environmental equipment does not alone meet the first recognition criterion, ie it does not result in an inflow of future economic benefits.

Expenditure on this equipment is, however, recognised as an asset when it enables the entity to obtain future economic benefits from related assets in excess of those that it would obtain otherwise.

### 2.1.2 Complex assets

Some assets are made up of a number of component parts. For example, an aircraft may include the body, interior and engines. Each of these parts is likely to have a different useful life and so need replacing at different times. In this case, the cost of replacing a component is recognised as part of the carrying amount of the asset. Each part of a complex asset is depreciated separately to its expected replacement date (see Section 3).

### 2.1.3 Major inspections

In order to operate, some assets must have a periodic inspection. The cost of such inspections is capitalised as part of the cost of the asset and depreciated as a separate component to the date of the next inspection.

## 2.2 Initial measurement

An item of PPE is initially measured at cost. This comprises:

- Purchase price, **including** any import duties paid, but **excluding** any trade discount and sales tax paid
- Directly attributable costs of bringing the asset to working condition for its intended use

- Initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located

### 2.2.1 Purchase price

Where an asset is acquired in an exchange transaction, its deemed purchase price is its fair value unless either of the following applies:

- (a) The exchange transaction lacks commercial substance
- (b) The fair value of neither the asset received nor that given up is reliably measurable

In this case, the acquired item is measured at the carrying amount of the asset given up.

### 2.2.2 Directly attributable costs

Directly attributable costs include:

- The cost of site preparation
- Initial delivery and handling costs
- Installation and assembly costs
- Professional fees
- Costs of testing whether the asset is working properly, after deducting the net proceeds from selling samples produced when testing equipment
- Staff costs arising directly from the construction or acquisition of the asset

The following costs cannot be capitalised as part of the cost of an asset:

- The costs of opening a new facility
- The costs of introducing a new product or service (including advertising and promotional costs)
- The costs of conducting business in a new location or with a new class of customer
- The costs of staff training
- Administration and general overheads
- The cost of relocating all or part of an entity's operations
- Initial operating losses
- Costs incurred while an item is capable of operating in the manner intended by management but is yet to be brought into use

### 2.2.3 Dismantling and removal costs

An entity may have an obligation to dismantle and remove an asset at the end of its useful life or to put right land affected by the operation of the asset. This obligation may be legal or constructive (whereby an entity has stated publicly that it will dismantle and remove the asset or rectify damage done by it).

In this case, the present value of the expected costs of dismantling, removing and rectification are capitalised as part of the cost of the asset and also recognised as a provision in accordance with LKAS 37 (see Chapter 11).

## 2.3 Borrowing costs

LKAS 23 *Borrowing costs* requires that eligible borrowing costs in respect of qualifying assets are capitalised as part of the cost of the asset. Eligible borrowing costs are those borrowing costs that are directly related to the acquisition, construction or production of a qualifying asset.

### 2.3.1 Definitions



**Borrowing costs** are interest and other costs that an entity incurs in connection with the borrowing of funds.

A **qualifying asset** is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

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Eligible borrowing costs are those borrowing costs that are directly related to the acquisition, construction or production of a qualifying asset that would have been avoided if the expenditure on the asset had not been made.

Qualifying assets may include inventories (Chapter 10), property plant and equipment, intangible assets (Chapter 7) and investment properties (Chapter 6).

### 2.3.2 Calculation of eligible borrowing costs

The calculation of eligible borrowing costs is simple where funds are borrowed specifically for the purpose of obtaining and developing a qualifying asset. In this case, the borrowing costs to be capitalised are the actual borrowing costs incurred less any investment income on the temporary investment of those borrowings.

Where funds are borrowed generally and some of those funds are used for the purpose of obtaining and developing a qualifying asset, the borrowing costs eligible for capitalisation should be calculated by applying a capitalisation rate to the expenditure on the asset. The capitalisation rate is the weighted average of the

borrowing costs applicable to the borrowings of the entity that are outstanding during the period.



### 2.3.3 Example: capitalisation rate

An entity has two outstanding items of debt during the year ended 31 December 20X3:

- An Rs. 80m bank loan with an interest rate of 7%
- Rs. 100m loan notes with an interest rate of 9%

The capitalisation rate to be applied to expenditure on qualifying assets funded using these general borrowings is:

$$(80/80 + 100) \times 7\% + (100/80 + 100) \times 9\% \\ = 8.1\%$$

### 2.3.4 Commencement and cessation of capitalisation

Borrowing costs in respect of a qualifying asset are capitalised when:

- Expenditure on the asset is being incurred
- Borrowing costs are being incurred
- Activities necessary to prepare the asset for intended use or sale are being incurred

The capitalisation of borrowing costs ceases when substantially all of the activities necessary to prepare an asset for intended use or sale are complete. This is usually when physical construction of the asset is complete.

The capitalisation of borrowing costs is suspended when the active development of an asset is unexpectedly suspended for an extended period, eg due to strike action.



### 2.3.5 Example: capitalised borrowing costs

Continuing with the example in 2.3.3. The entity draws down Rs. 10m to spend on the acquisition of a property and initial development costs on 1 March 20X3. It draws down a further Rs. 5m on 1 November 20X3 to complete the development. The development project was completed on 1 December 20X3.

The borrowing costs to be capitalised are:

First draw down Rs. 10m × 8.1% × 9/12 months	=	Rs. 607,500
Second draw down Rs. 5m × 8.1% × 1/12 months	=	<u>Rs. 33,750</u>
Capitalised borrowing costs		Rs. 641,250

## 2.4 Subsequent costs

Subsequent expenditure is added to the carrying amount of the asset when it is probable that future economic benefits, in excess of the originally assessed standard of performance of the existing asset, will flow to the entity. All other subsequent expenditure, including repairs and maintenance, is simply recognised as an expense in the period in which it is incurred.

The following are examples of expenditure that will result in increased economic benefits:

- (a) Modification of an item of plant to extend its useful life, including increased capacity
- (b) Upgrade of machine parts to improve the quality of output
- (c) Adoption of a new production process leading to large reductions in operating costs



### QUESTION

### Cost of PPE

Perera Properties PLC constructs residential and commercial properties throughout Sri Lanka. On 1 March 20X4 it commenced work constructing a new head office property. The work was completed on time on 31 December 20X4, despite work being halted throughout the month of August due to a combination of strike action and inclement weather.

Costs incurred in constructing the property were as follows.

	Rs'000
Site selection	800
Cost of acquiring site (including Rs. 1m legal fees)	25,000
Site levelling and preparation	1,600
Architects' fees	2,700
Materials	6,700
Labour costs (including Rs. 900,000 pension costs)	12,300
Proportion of administration department costs	700

The project was mainly financed by way of a specific loan for Rs. 40m with an interest rate of 8% per annum. This was arranged and received on 1 February 20X4 and was due to be repaid in 20X8.

### Required

**Calculate** the carrying amount of the head office property at 31 December 20X4.

**ANSWER**

	Rs'000
Cost of acquiring site (including Rs. 1m legal fees)	25,000
Site levelling and preparation	1,600
Architects' fees	2,700
Materials	6,700
Labour costs (including Rs. 900,000 pension costs)	12,300
Capitalised borrowing costs	<u>2,400</u>
Carrying amount at 31 December 20X4	50,700

Borrowing costs are capitalised only from 1 March (when work began) to 31 December (when work was completed). Capitalisation is suspended in August. Therefore, the amount to be capitalised is:

$$\text{Rs. } 40\text{m} \times 8\% \times 9/12\text{m} = \text{Rs. } 2.4\text{m}$$

### 3 Depreciation



**Depreciation must be charged on all assets except land. The depreciable amount of an asset is allocated on a systematic basis over its useful life.**

Depreciation is charged on all assets with the exception of land. Expenditure on repairs and maintenance does not negate the need to charge depreciation.

#### 3.1 Definitions

LKAS 16 contains the following definitions in relation to depreciation.



**Depreciation** is the systematic allocation of the depreciable amount of an asset over its useful life.

**Depreciable amount** is the cost of an asset, or other amount substituted for cost, less its residual value.

**Residual value** is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

**Useful life** is either of the following:

- (a) The period over which an asset is expected to be available for use by an entity
  - (b) The number of production or similar units expected to be obtained from the asset by the entity
- (LKAS 16)





### 3.1.1 Example: depreciation

An asset cost Rs. 300,000 and has a residual value of Rs. 40,000. The asset has a useful life of 20 years.

The depreciation charge per annum is therefore:

$$(300,000 - 40,000)/20 \text{ years} = \text{Rs. } 13,000$$

## 3.2 Commencement and cessation of depreciation

Depreciation commences when an asset is in the location and condition necessary for it to be used in the manner intended by management.

Depreciation ceases at the earlier of either of the following:

- Classification as held for sale in accordance with SLFRS 5 (see Chapter 17)
- Disposal

Depreciation continues even if an asset becomes idle.

## 3.3 Residual value

Residual value may be a scrap value, a secondhand value or another value.

In many cases, residual value is insignificant and so immaterial in the calculation of depreciation.

Where residual value exceeds carrying amount, the depreciation charge is zero.

Residual value must be reviewed at least at each financial year end, and if the new estimate is different from previous estimates, the change is accounted for as a change in accounting estimate in accordance with LKAS 8 (see Chapter 4).

## 3.4 Useful life

The following factors should be considered in determining the useful life of an asset.

- Expected usage of the asset (ie the asset's expected capacity or physical output)
- Expected physical wear and tear
- Technical or commercial obsolescence as a result of changes in production or changes in market demand for the output of the asset
- Legal or similar limits on use of the asset

Useful life refers to the period for which an asset is useful to the entity using it. This may differ from the asset's economic life.

Useful life must be reviewed at least at each financial year end, and if the new estimate is different from previous estimates, the change is accounted for as a change in accounting estimate in accordance with LKAS 8 (see Chapter 4).



### QUESTION

### Depreciation changes in estimates

Adikari Gardens (Pvt) Ltd acquired a large piece of machinery on 1 August 20X2 at a cost of Rs. 120,000. The machine was estimated to have a residual value of Rs. 15,000 and a useful life of 10 years. On 31 December 20X3, the residual value of the machine was reassessed to be nil and the remaining useful life to be five years. These estimates were applied from 1 January 20X4.

### Required

**Calculate** the depreciation charge in each of the years ended 31 December 20X2, 20X3 and 20X4.

### ANSWER

	Depreciation charge Rs.	Carrying amount Rs.
Y/e 31 December 20X2 (120 – 15)/10 years × 5/12 years	<b>4,375</b>	115,625
Y/e 31 December 20X3 (120 – 15)/10 years	<b>10,500</b>	105,125
Y/e 31 December 20X4 (105,125/5 years)	<b>21,025</b>	84,100

### 3.5 Depreciation method

The depreciation method used should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. Appropriate methods may include:

- The straight line method in which an equal depreciation charge arises each year
- The reducing balance method in which depreciation charges are higher in earlier years of use and less in later years
- The units of production method which results in a charge based on expected use or output

The depreciation method must be reviewed at least at each financial year end and, if there is a significant change in the pattern of consumption of benefits, the method is changed to reflect the new pattern. The change is accounted for as a change in accounting estimate in accordance with LKAS 8 (see Chapter 4).

**QUESTION****Change in depreciation method**

A company acquired an asset on 1 January 20X2 at a cost of Rs. 500,000, and commenced depreciation immediately on a straight line basis. The asset was estimated to have no residual value and a useful life of 25 years. After two years, it became apparent that the pattern of consumption of benefits was such that the reducing balance method of depreciation would be more appropriate using a rate of 25%.

**Required**

**Calculate** the depreciation charge in each of the years ended 31 December 20X2, 20X3 and 20X4.

**ANSWER**

	<b>Depreciation charge Rs.</b>	<b>Carrying amount Rs.</b>
Y/e 31 December 20X2 500/25 years	<b>20,000</b>	480,000
Y/e 31 December 20X3 500/25 years	<b>20,000</b>	460,000
Y/e 31 December 20X4 460,000 × 25%	<b>115,000</b>	345,000

**3.6 Complex assets**

As we saw in Section 2 of the chapter, some assets are made up of a number of component parts. These parts generally have different useful lives. It therefore follows that depreciation is calculated for each component separately.

**3.6.1 Example: complex asset depreciation**

An aircraft is made up of the following parts.

Body	Cost Rs. 120m	Useful life of 25 years
Interior	Cost Rs. 60m	Useful life of 10 years
Engines	Cost Rs. 90m	Useful life of 15 years

In addition, the aircraft needs a major inspection every five years at a cost of Rs. 10m.

The annual depreciation charge is therefore:	Rs'000
Body (120/25 years)	4,800
Interior (60/10 years)	6,000
Engines (90/15 years)	6,000
Inspection (10/5 years)	<u>2,000</u>
	18,800

## 4 Revaluation



**LKAS 16 allows a choice of measuring assets using either the cost model or the revaluation model.**

LKAS 16 allows assets to be measured after initial recognition using either the cost model or the revaluation model.

### 4.1 LKAS 16 requirements

LKAS 16 has strict requirements in respect of the application of the revaluation model:

- (1) Where the revaluation model is adopted, it must be applied to an entire class of assets. This means that an entity cannot 'cherry pick' the particular assets that it believes have increased in value and apply the revaluation model to those assets only.
- (2) The revaluation must be kept up to date, such that the carrying amount of an asset does not differ significantly from its fair value.

### 4.2 Upwards revaluations

An upwards revaluation is recognised as other comprehensive income and accumulated in equity in a revaluation surplus.

The exception to this rule is where the asset has previously been revalued downwards. In this case, the upwards revaluation first reverses any downwards revaluation previously charged to profit or loss. Any excess is recognised as other comprehensive income.

### 4.2.1 Subsequent depreciation

A revalued asset is depreciated in the same way as an asset held under the cost model, with depreciation spreading the revalued amount over the asset's remaining useful life.

The consequence of the revaluation is a higher annual depreciation charge. The difference between the new depreciation charge, based on the revalued carrying amount, and the old depreciation charge, based on the original cost of the asset, is known as excess depreciation. LKAS 16 allows entities to transfer an amount equal to the excess depreciation from the revaluation surplus to retained earnings in the equity section of the statement of financial position, if they wish to do so.

### 4.3 Downwards revaluations

A downwards revaluation is treated in the same way as an impairment (see Chapter 8) and recognised in profit or loss.

The exception to this rule is where the asset has previously been revalued upwards. In this case, the downwards revaluation is charged to other comprehensive income to the extent that a revaluation surplus exists in respect of the asset. Any excess is recognised in profit or loss.



#### QUESTION

#### Revaluation

A company acquired land on 1 January 20X1 at a cost of Rs. 65m. The land was subsequently revalued upwards to Rs. 68m on 31 December 20X4. At the end of 20X7, as a result of a fall in market values, the fair value of the land fell to Rs. 63m. The market recovered in 20X9 and by the end of that year the land had a fair value of Rs. 70m.

#### Required

**Record** each revaluation.

#### ANSWER

##### 31 December 20X4

DEBIT	PPE – land	Rs. 3m	
CREDIT	Other comprehensive income – revaluation surplus		Rs. 3m

##### 31 December 20X7

DEBIT	Other comprehensive income – revaluation surplus	Rs. 3m	
DEBIT	Profit or loss	Rs. 2m	
CREDIT	PPE – land		Rs. 5m

**31 December 20X4**

DEBIT	PPE – land	Rs. 7m	
CREDIT	Profit or loss		Rs. 2m
CREDIT	Other comprehensive income – revaluation surplus		Rs. 5m

**5 Disposals**

**On the disposal of an item of PPE, a gain or loss is recognised in profit or loss.**

The profit or loss on the disposal of a non-current asset is the difference between:

- The carrying amount of the asset at the time of its sale
- Its net sale price, which is the price minus any costs of making the sale

A profit is made when the sale price exceeds the carrying amount, and a loss is made when the sale price is less than the carrying amount.

**5.1 Example: disposal**

An item of equipment was purchased on 1 July 20X3 at a cost of Rs. 100,000 and depreciation commenced immediately, based on a 10-year useful life and no residual value. As a result of a change in business strategy, the equipment was surplus to requirement at 31 December 20X7 and was sold for Rs. 54,000.

**Required**

**Explain** what profit or loss on disposal is recognised on the sale.

**Solution**

At the disposal date, the equipment has been used for 4.5 years. It therefore has a carrying amount of Rs.  $100,000 \times 5.5/10$  years = Rs. 55,000.

Therefore, a loss on disposal of Rs. 55,000 – Rs. 54,000 = Rs. 1,000 is recognised.

**5.2 Disposals of revalued assets**

When a revalued asset is disposed of, the revaluation surplus in respect of that asset becomes realised.

The related revaluation surplus is therefore transferred to retained earnings. This is disclosed in the statement of changes in equity.

**QUESTION****Disposal of revalued asset**

Hippala Imports PLC sold one of its warehouses on 31 December 20X4 for Rs. 57m. The warehouse had originally cost Rs. 40m on 1 January W6. Depreciation commenced immediately, based on a 50-year useful life.

On 1 January 20X1 the warehouse was revalued to Rs. 50m and depreciation continued based on the original useful life. The warehouse was further revalued on 1 January 20X4 to Rs. 55m.

On 31 December 20X4, the warehouse was sold for Rs. 57m.

Hippala Imports adopts accounting policies and practices that maximise distributable profits.

**Required**

**Prepare** relevant extracts of the statement of profit or loss and the statement of changes in equity for the year ended 31 December 20X4.

**ANSWER****Statement of profit or loss**

	<b>Rs.</b>
Depreciation charge	1,309
Gain on disposal (57,000 – 53,691)	3,309

**Statement of changes in equity**

	<b>Revaluation surplus Rs'000</b>	<b>Retained earnings Rs'000</b>	<b>Total Rs'000</b>
1 January 20X4	13,067	X	X
Other comprehensive income	8,333	X	X
Transfers (20,891 + 509)	<u>(21,400)</u>	21,400	–
31 December 20X4	-	X	X

*Workings*

	<i>Carrying amount Rs'000</i>	<i>Revaluation surplus Rs'000</i>
1 January 20W6	40,000	
Depreciation 20W6 (40,000/50 years)	(800)	
Depreciation 20W7	(800)	
Depreciation 20W8	(800)	
Depreciation 20W9	(800)	
Depreciation 20X0	<u>(800)</u>	
Carrying amount 31 December 20X0	36,000	
Revaluation surplus	<u>14,000</u>	14,000
1 January 20X1	50,000	
Depreciation 20X1 (50,000/45 years)	(1,111)	
Excess depreciation (1,111 – 800)		(311)
Depreciation 20X2	(1,111)	(311)
Depreciation 20X3	<u>(1,111)</u>	<u>(311)</u>
Carrying amount 31 December 20X3	46,667	13,067
Revaluation surplus 1 January 20X4	8,333	8,333
Carrying amount after revaluation	55,000	
Depreciation (55,000/42 years)	(1,309)	
Excess depreciation (1,309 – 800)		<u>(509)</u>
Carrying amount 31 December 20X4	53,691	20891
Disposal	(53,691)	(20,891)

## 6 Disclosure



**LKAS 16 requires a number of disclosures including a reconciliation of carrying amount at the start of the year to the end of the year.**

### 6.1 LKAS 16 disclosures

For each class of property, plant and equipment, the following must be disclosed.

- Measurement bases** for determining the gross carrying amount (if more than one, the gross carrying amount for that basis in each category)
- Depreciation methods** used
- Useful lives** or depreciation rates used



- (d) **Gross carrying amount** and accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period
- (e) **Reconciliation** of the carrying amount at the beginning and end of the period showing:
  - (i) Additions
  - (ii) Disposals
  - (iii) Acquisitions through business combinations
  - (iv) Increases/decreases during the period from revaluations and from impairment losses
  - (v) Impairment losses recognised in profit or loss
  - (vi) Impairment losses reversed in profit or loss
  - (vii) Depreciation
  - (viii) Net exchange differences (from translation of statements of foreign entity)
  - (ix) Any other movements

The financial statements should also disclose:

- (a) Any recoverable amounts of property, plant and equipment
- (b) Existence and amounts of **restrictions on title**, and items pledged as security for liabilities
- (c) Accounting policy for **the estimated costs of restoring the site**
- (d) Amount of expenditures on account of **items in the course of construction**
- (e) Amount of commitments to **acquisitions**

Additional disclosures are required in respect of revalued assets. These are:

- (a) Basis used to revalue the assets
- (b) Effective date of the revaluation
- (c) Whether an independent valuer was involved
- (d) Carrying amount of each class of property, plant and equipment that would have been included in the financial statements had the assets been carried at cost less accumulated depreciation and accumulated impairment losses
- (e) Revaluation surplus, indicating the movement for the period and any restrictions on the distribution of the balance to shareholders

## 6.2 LKAS 23 disclosures

LKAS 23 requires that the following information is disclosed in respect of borrowing costs:

- The amount of borrowing costs capitalised during the period
- The capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation

**CHAPTER ROUNDUP**

- ↳ **LKAS 16 Property, plant and equipment provides guidance on recognising and measuring non-current assets. These usually form the largest balance in the statement of financial position.**
- ↳ **The recognition criteria of LKAS 16 are the same as those in the Conceptual Framework. An item of PPE is initially measured at cost.**
- ↳ **Depreciation must be charged on all assets except land. The depreciable amount of an asset is allocated on a systematic basis over its useful life.**
- ↳ **LKAS 16 allows a choice of measuring assets using either the cost model or the revaluation model.**
- ↳ **On the disposal of an item of PPE, a gain or loss is recognised in profit or loss.**
- ↳ **LKAS 16 requires a number of disclosures including a reconciliation of carrying amount at the start of the year to the end of the year.**


**PROGRESS TEST**

- 1 Can the cost of a company's own workforce be included in the initial measurement of an item of PPE?
- 2 When can eligible borrowing costs related to a qualifying asset be capitalised?
- 3 How is a downwards revaluation recognised?
- 4 How often must an asset measured under the revaluation model be revalued?
- 5 Under what circumstances can the method used to depreciate a particular asset be changed?
- 6 A company buys a property on 1 January 20X3 at a cost of Rs. 45m and starts depreciating it over a 50-year useful life. Property prices remain constant throughout 20X3; however, towards the end of 20X4 there is drop in the market value of commercial properties and the market value of the property falls to Rs. 39m at 31 December 20X4.

The company holds all properties under the revaluation model of LKAS 16.

What is the charge to profit or loss in the year ended 31 December 20X4?

- A Rs. 0.9m
  - B Rs. 4.2m
  - C Rs. 5.1m
  - D Rs. 6m
- 7 Which of the following may not be capitalised as part of the cost of Abekoon Development PLC's new head office?
    - A The pension costs of Abekoon Development PLC's employees who were involved in building the head office
    - B The cost of identifying an appropriate site for the head office
    - C Architects' fees
    - D The costs of removing the old property on the chosen site
  - 8 Perera Properties PLC acquires a machine on 1 January 20X5 at a cost of Rs. 380,000. The machine has a residual life of Rs. 60,000 and a 10-year useful life. At 31 December 20X8, it is decided that the machine has a remaining useful life of three years and no residual value. The machine was sold on 31 December 20X9 for Rs. 150,000. What was the profit or loss on disposal?
    - A Rs. 18,000 loss
    - B Rs. 2,000 loss
    - C Rs. 18,000 profit
    - D Rs. 2,000 profit

## ANSWERS TO PROGRESS TEST

- 1 Yes. PPE is initially measured at purchase price plus directly attributable costs in bringing the asset into working condition for its intended use. Directly attributable costs include staff costs arising directly from the construction or acquisition of an asset.
- 2 When:
  - Expenditure is incurred for the asset
  - Borrowing costs are incurred
  - Necessary to prepare the asset for intended use or sale
- 3 If the asset has been revalued upwards previously:
  - (a) As a reduction in the revaluation surplus relating to the asset
  - (b) Any excess in profit or loss

If the asset has not been revalued upwards previously, the downwards revaluation is recognised in profit or loss in its entirety.
- 4 As often as is necessary to ensure that the carrying amount does not differ materially from fair value.
- 5 Where there is a significant change in the expected pattern of consumption of the future economic benefits embodied in an asset.
- 6 The answer is **C**. The charge to profit or loss in 20X4 includes:
  - (1) Depreciation for the year of Rs. 45m/50 years = Rs. 900,000.
  - (2) Impairment loss of  $(45\text{m} \times 48/50 \text{ years}) - 39\text{m} = 4.2\text{m}$ .

Therefore, a total of Rs. 5.1m.
- 7 The answer is **B**. The costs of site selection are not eligible for capitalisation; however the costs of site preparation are.
- 8 The answer is **A**.
 

Depreciation per annum is initially Rs. 32,000  $((\text{Rs. } 380,000 - 60,000)/10 \text{ years})$ . Therefore depreciation for the 4 years to 31 December 20X8 is Rs. 128,000 and the carrying amount at 31 December 20X8 is Rs. 252,000.

The carrying amount of the machine at 31 December 20X9 is Rs. 168,000. A loss of Rs. 18,000 on disposal therefore arises.



# Investment Property

## INTRODUCTION

Where an entity holds a property in order to benefit from its capital appreciation or the rental income it generates, rather than use it in the ordinary course of business, the accounting treatment applied is provided by LKAS 40 *Investment property* rather than LKAS 16 *Property, plant and equipment*.

Knowledge Component			
<b>2</b>	<b>Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)</b>		
<b>2.2</b>	<b>Level B</b>	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1 Investment property	2.2
2 Recognition and measurement	2.2
3 Transfers and disposals	2.2
4 Disclosure	2.2

**LKAS 40 Learning objectives**

- Describe investment property.
- Explain the criteria to be met to recognise an investment property.
- Explain the initial measurement of investment property.
- Compute the cost of an investment property.
- Differentiate the fair value model and cost model applicable for subsequent measurement of investment property.
- Explain the adjustments to be made in respect of transfers to and from, and disposal of, investment properties.
- Outline the disclosures to be made in respect of investment properties.

**1 Investment property**

An entity may own land or a building **as an investment** rather than for use in the business. The property may therefore generate cash flows that are largely independent of other assets that the entity holds. The treatment of investment property is covered by LKAS 40.

The objective of LKAS 40 *Investment property* is to prescribe the accounting treatment for investment property and related disclosure requirements.

The standard provides a number of definitions, including the definition of an investment property.

**1.1 Definitions**

**Investment property** is property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for either of the following.



- (a) Use in the production or supply of goods or services or for administrative purposes
- (b) Sale in the ordinary course of business

**Owner-occupied property** is property held by the owner (or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

**Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Cost** is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction.

**Carrying amount** is the amount at which an asset is recognised in the statement of financial position.

### 1.1.1 Property held under an operating lease

Note that the definition of investment property states that it is a property that is owned or held under a finance lease by an entity. The standard goes on to state that a property interest that is held by a lessee under an **operating lease** may be classified and accounted for as an **investment property**, if and only if the property would otherwise meet the definition of an investment property and the lessee uses the LKAS 40 **fair value model**. This classification is available on a property-by-property basis.

## 1.2 Application of the definition of investment property

As we have seen, investment property **is** used to earn rentals or for capital appreciation and **is not** used or sold by an entity in its normal operations.

LKAS 40 provides examples of how this definition is applied.

### 1.2.1 Investment property

**Examples** of property that meets the definition of investment property are outlined below.

Example	Application of definition
Land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.	Held for capital appreciation.
Land held for a currently undetermined use.	Assumed to be held for capital appreciation.
A building owned by the reporting entity (or held by the entity under a finance lease) and leased out under an operating lease.	Held to earn rentals.
A building that is vacant but is held to be leased out under one or more operating leases.	Held with the intention of earning rentals.
Property that is being constructed or developed for future use as investment property.	Held with the intention of earning rentals or for capital appreciation in the future.

### 1.2.2 Not investment property

**Examples** of property that does not meet the definition of investment property are outlined below.

Example	Application of definition
Property that is complete or under construction and intended for sale in the ordinary course of business.	Held to be sold in the ordinary course of business; the applicable standard is LKAS 2 <i>Inventories</i> .
Property under construction on behalf of third parties.	Held to be sold in the ordinary course of business; the applicable standard is LKAS 11 <i>Construction contracts</i> .
Owner-occupied property, property held or under development for future owner occupation and owner-occupied property awaiting disposal.	Held for use in the ordinary course of business; the applicable standard is LKAS 16 <i>Property, plant and equipment</i> .

Example	Application of definition
Property that is leased to another entity under a finance lease.	The lessor does not have a property; they have a lease receivable, hence application of the definition is not relevant.



## QUESTION

## Investment property

Colombo Developments Ltd owns a block of apartments on the outskirts of Colombo. These are let to skilled employees of the company who live overseas but are required to be based in Colombo during the week due to work commitments. A below-market rate of rent is charged to the employees.

### Required

**Explain** how the property is classified in the financial statements of Colombo.

## ANSWER

This property is classified as owner-occupied and accounted for under LKAS 16 *Property, plant and equipment*.

All property that is owned (or held under a finance lease) by a company and occupied by that company's employees is deemed to be owner-occupied, regardless of whether the employees pay rent at market rates. This is because the property is not held with the intention of collecting rentals, but is held with the intention of housing employees.

### 1.3 Investment property in a group situation

A property may be owned by one group company, Company A, and leased to another, Company B.

- (a) In the individual financial statements of Company A, this property is investment property and accounted for under LKAS 40.
- (b) In the consolidated financial statements of the Company A Group, this property will be regarded as owner-occupied (because it is occupied by the group) and will therefore be treated in accordance with LKAS 16.

## 2 Recognition and measurement



**An investment property is initially recognised at cost; subsequently an entity may make an accounting policy choice and adopt either the fair value or the cost model to measure investment property.**

### 2.1 Recognition

The recognition criteria of LKAS 40 mirror those of the Conceptual Framework: investment property should be recognised as an asset when two conditions are met:

- (a) It is probable that the future economic benefits that are associated with the investment property will flow to the entity.
- (b) The cost of the investment property can be measured reliably.

### 2.2 Initial measurement

An investment property should be measured initially at its **cost**, including transaction costs.

The cost of an investment property includes:

- Its purchase price
- Directly attributable expenditure, including professional fees, property transfer taxes and other transaction costs

The cost of an investment property does not include start-up costs, operating losses before the investment property is fully occupied or any abnormal costs of wasted material, labour or other resources incurred in the construction or development of the property.



#### 2.2.1 Example: cost of investment property

Kalugala Ltd acquired a property on 1 October 20X5, which it intends to renovate prior to renting out to commercial tenants. The property cost Rs. 6.5m, including Rs. 165,000 legal fees and Rs. 10,000 bank transfer charges. Kalugala intends to spend Rs. 2m on renovations before the property can be rented out. The renovations should take three months; if they extend beyond this time, the cost in lost income to Kalugala will be Rs. 16,000 per month. When the property is rented out, Kalugala expects to pay Rs. 2,000 per month in maintenance costs.

**Required**

**State** at what cost the property is initially measured. **Explain** how this cost might subsequently change.

**Solution**

- (a) The property is an investment property, as it is under development to be used for rental income in the future.
- (b) It is initially measured on 1 October 20X5 at purchase price including transaction costs. That is, Rs. 6.5m (ie the legal fees and bank transfer charges are included in the cost rather than expensed to profit or loss).
- (c) The renovation costs are capitalised as part of the cost of the property when they are incurred; they cannot be recognised as part of the cost of the property at 1 October 20X5.
- (d) If the renovations overrun, there is not accounting entry in respect of the lost income; this is an abnormal cost and it cannot be credited to profit or loss and debited to form part of the cost of the property.
- (e) When the property is rented out, the maintenance costs must be expensed to profit or loss and are not capitalised as part of the cost of the property.

**2.2.2 Cost of an investment property held under a lease**

A property interest held under a lease and classified as an investment property is accounted for as if it were a finance lease. The initial cost of the investment property recognised in the financial statements is therefore the lower of the fair value of the property and the present value of the minimum lease payments. An equivalent amount is recognised as a liability.

**2.3 Subsequent measurement**

LKAS 40 requires an entity to choose between two models:

- The fair value model
- The cost model

Whatever policy it chooses should be applied to all of its investment property.

Where an entity chooses to classify a property held under an operating lease as an investment property, there is no choice. The fair value model must be used for all the entity's investment property, regardless of whether it is owned or leased.

### 2.3.1 Fair value model

Where the fair value model is applied, an entity should re-measure all of its investment property to fair value at each reporting date and recognise any gains or losses on remeasurement in profit or loss.

If an investment property is self-constructed, any difference between the carrying amount of the property (cost) and the fair value on the date of completion is recognised in profit or loss.

Fair value is established in accordance with SLFRS 13 *Fair value measurement*, and the fair value should reflect:

- Rental income from current leases
- Other assumptions that market participants would use when pricing investment property under current market conditions

In determining fair value, an entity should not double count assets. For example, elevators or air conditioning are often an integral part of a building and should be included in the investment property, rather than recognised separately.

### 2.3.2 Cost model

An entity that applies the cost model should measure its investment property using the cost model in LKAS 16, ie at depreciated cost, less any accumulated impairment losses.

Entities that choose the cost model are required to measure the fair value of investment properties for disclosure purposes, even though this is not the value at which investment property is measured in the financial statements.

### 2.3.3 Changing models

An entity should not change from one model to the other unless the change will result in a more appropriate presentation.

LKAS 40 states that it is highly unlikely that a change from the fair value model to the cost model will result in a more appropriate presentation.



#### QUESTION

#### Fair value model

Moratuwa Properties Ltd acquired a retail park on 1 August 20X5 at a cost of Rs. 9m. The company incurred transaction costs of Rs. 500,000 on the purchase. At 31 December 20X5, the property was determined by an external valuer to have a fair value of Rs. 10.2m. During 20X6, there was a market-wide fall in property prices and the fair value of the retail park at 31 December 20X6 was Rs. 9.9m.

Moratuwa Properties Ltd applies the LKAS 40 fair value model.

**Required**

**Prepare** relevant extracts from the financial statements of Moratuwa Properties Ltd for the years ended 31 December 20X5 and 20X6.

**ANSWER**

<b>Statement of financial position at 31 December</b>	<b>20X6</b>	<b>20X5</b>
	<b>Rs'000</b>	<b>Rs'000</b>
Investment property	9,900	10,200
<b>Statement of profit or loss for the year ended 31 December</b>	<b>20X6</b>	<b>20X5</b>
	<b>Rs'000</b>	<b>Rs'000</b>
Gain/(loss) on remeasurement of investment properties to fair value $(9.9 - 10.2)/(10.2 - 9.5)$	(300)	700

**3 Transfers and disposals**

**LKAS 40 provides guidance on the value at which property should be transferred in and out of the investment property category.**

**3.1 Transfers**

Transfers to or from investment property should only be made when there is a change in use. LKAS 40 provides the following examples.

- (a) Owner occupation commences: the investment property is transferred to property, plant and equipment (LKAS 16)
- (b) Owner occupation ceases: the property is transferred to investment property (LKAS 40)
- (c) Development of an investment property with a view to sale commences: the investment property is transferred inventories (LKAS 2)
- (d) An operating lease to another party commences: the property is transferred to investment property (LKAS 40)

**3.1.1 Transfers where the cost model is applied**

Where a property is transferred to or from the investment property category and the cost model is applied, the carrying amount of the property does not change on the transfer.

### 3.1.2 Transfers where the fair value model is applied

Where a property is transferred to or from the investment property category and the fair value model is applied, the following rules regarding measurement apply.

- (a) For a transfer from investment property to owner-occupied property or inventories, the deemed cost for subsequent accounting is the fair value at the date of change in use.
- (b) For a transfer from owner-occupied property to investment property, any difference between the previous carrying amount of the property and its fair value is accounted for as an LKAS 16 revaluation at the point of transfer.
- (c) For a transfer from inventories to investment property, any difference between the previous carrying amount of the property and fair value at the date of transfer is recognised in profit or loss.



### 3.1.3 Example: transfer to investment property

A business owns a building that it has been using as a head office. In order to reduce costs, on 30 June 20X9 it moved its head office functions to one of its production centres and is now letting out its head office. Company policy is to use the fair value model for investment property.

The building had an original cost on 1 January 20X0 of Rs. 250,000 and was being depreciated over 50 years. At 31 December 20X9, its fair value was judged to be Rs. 350,000.

#### Required

**Explain** how this will appear in the financial statements at 31 December 20X9.

#### Solution

The building will be depreciated up to 30 June 20X9.

	Rs
Original cost	250,000
Depreciation 1.1.X0 – 1.1.X9 ( $250/50 \times 9$ )	(45,000)
Depreciation to 30.6.X9 ( $250/50 \times 6/12$ )	<u>(2,500)</u>
Carrying amount at 30.6.X9	202,500
Revaluation surplus	<u>147,500</u>
Fair value at 30.6.X9	<u><u>350,000</u></u>

The difference between the carrying amount and fair value is taken to a revaluation surplus in accordance with LKAS 16.

The building will be subject to fair value remeasurement at each year end, and any gains or losses that arise will be recognised in profit or loss.



If at the end of the following year the fair value of the building is found to be Rs. 380,000, Rs. 30,000 will be credited to profit or loss.

### 3.2 Disposals

An investment property is derecognised on disposal or when it is permanently withdrawn from use and no future economic benefits are expected from its disposal.

Disposal may be achieved by a sale or by entering into a finance lease.

Any gain or loss on disposal is the difference between the net disposal proceeds and the carrying amount of the asset; it is recognised in profit or loss.

Compensation from third parties for investment property that was impaired, lost or given up is recognised in profit or loss when the compensation becomes receivable.

## 4 Disclosure



**LKAS 40 requires a number of general disclosures together with additional disclosures, depending on whether the fair value model or cost model is applied.**

### 4.1 General disclosures

An entity with investment properties must disclose the following.

- (a) Whether it applies the fair value or the cost model
- (b) The criteria used to distinguish between investment property, owner-occupied property and inventory where classification is difficult
- (c) The extent that the fair value of investment property (as measured or disclosed in the financial statements) is based on valuation by an independent, qualified and experienced valuer
- (d) Amounts recognised in profit or loss in respect of:
  - Rental income from investment property
  - Direct operating expenses of investment property which did and did not generate rental income in the period
- (e) Details of restrictions on the realisability of investment property or the remittance of income or the proceeds of disposal

- (f) Contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements

## 4.2 Fair value model disclosures

Where the fair value model is applied, the following must be disclosed in addition to the general disclosures listed above.

- (a) Whether, and in what circumstances, property interests held under operating leases are classified as investment property
- (b) A reconciliation between the carrying amounts of investment property at the start and end of the period which details:
  - Additions (from acquisitions, subsequent expenditure and business combinations)
  - Assets classified as held-for-sale
  - Net gains or losses from fair value adjustments
  - Net exchange differences arising on translation of financial statements into a presentation currency
  - Transfers to and from inventories and owner-occupied property
  - Other changes

Where the fair value model is applied but an investment property is measured using the cost model because its fair value cannot be measured reliably, a description of the property must be provided, together with an explanation of why the fair value cannot be measured reliably and, if possible, a range of estimates within which the fair value is highly likely to lie.

## 4.3 Cost model disclosures

Where the cost model is applied, the following must be disclosed in addition to the general disclosures listed above.

- (a) The depreciation methods used and useful lives or depreciation rates
- (b) The gross carrying amount and the accumulated depreciation at the beginning and end of the period
- (c) A reconciliation between the carrying amounts of investment property at the start and end of the period which details:
  - Additions (from acquisitions, subsequent expenditure and business combinations)

- Assets classified as held-for-sale
  - Depreciation
  - Impairment losses recognised and reversed
  - Net exchange differences arising on translation of financial statements into a presentation currency
  - Transfers to and from inventories and owner-occupied property
  - Other changes
- (d) The fair value of the investment property, or if this cannot be reliably measured, a description of the property, an explanation of why the fair value cannot be measured reliably and, if possible, a range of estimates within which the fair value is highly likely to lie.



## CHAPTER ROUNDUP

- ↪ An entity may own land or a building **as an investment** rather than for use in the business. The property may therefore generate cash flows that are largely independent of other assets that the entity holds. The treatment of investment property is covered by LKAS 40.
- ↪ An investment property is initially recognised at cost; subsequently an entity may make an accounting policy choice and adopt either the fair value or the cost model to measure investment property.
- ↪ LKAS 40 provides guidance on the value at which property should be transferred in and out of the investment property category.
- ↪ LKAS 40 requires a number of general disclosures together with additional disclosures, depending on whether the fair value model or cost model is applied.


**PROGRESS TEST**

- 1 What is the definition of an investment property?
- 2 What is the initial cost of an owned investment property?
- 3 What is the initial cost of an investment property held under a finance lease?
- 4 Where the fair value model is applied, how is fair value established?
- 5 Under what circumstances can an entity change measurement models?
- 6 A company has two properties:
  - 1 Land which is currently unused; the company is unsure whether to develop a property on the land for sale or whether to keep the land and sell it when its market value rises.
  - 2 A part-finished apartment block; when the property is complete, the apartments will be let to third-party tenants.

Which of these properties is an investment property?

- A Neither of them
  - B 1 only
  - C 2 only
  - D Both of them
- 7 A company constructed an investment property at a cost of Rs. 4,200,000 during the year ended 31 December 20X1. This amount included:
    - Rs. 100,000 in architects' fees
    - Rs. 20,000 import taxes related to specific slate used on the roof
    - Rs. 40,000 of materials and labour costs that were wasted due to the project manager reading the architect's plans incorrectly

At what amount is the property initially measured?

- A Rs. 4,200,000
- B Rs. 4,160,000
- C Rs. 4,140,000
- D Rs. 4,060,000

- 8** On 1 May 20X5, Dias (Pte) Ltd signed an agreement to lease out a property under an operating lease which it had previously occupied itself. The property had been held at depreciated cost of Rs. 7m. On the date on which the agreement was signed, the property had a fair value of Rs. 9m.

What is the effect of the transfer on the financial statements of Dias (Pvt) Ltd, assuming that the company applies the fair value model to investment properties?

- A The investment property is initially recognised at Rs. 7m, and a gain of Rs. 2m is subsequently recognised in profit or loss.
- B A gain of Rs. 2m is recognised in profit or loss prior to the transfer, and the investment property is initially recognised at Rs. 9m.
- C The investment property is initially recognised at Rs. 7m, and a revaluation gain of Rs. 2m is subsequently recognised in other comprehensive income.
- D A revaluation gain of Rs. 2m is recognised in other comprehensive income prior to the transfer, and the investment property is initially recognised at Rs. 9m.

## ANSWERS TO PROGRESS TEST

- 1 A property used to earn rentals or for capital appreciation, rather than a property used or sold by an entity in its normal operations
- 2 Purchase price plus directly attributable expenditure (professional fees, property transfer taxes and other transaction costs)
- 3 The lower of the fair value of the property and the present value of the minimum lease payments
- 4 By reference to SLFRS 13
- 5 Only where this results in a more appropriate presentation. This is unlikely in the case of a change from the fair value to the cost model.
- 6 The answer is **D**. The future use of the land is undetermined and therefore it is deemed to be investment property.  
  
The apartment block is under construction for future use as investment property, and therefore it is classified now as investment property.
- 7 The answer is **B**. The architects' fees and the import taxes are part of the cost of the property.  
  
The wasted labour and materials costs are abnormal and should be recognised in profit or loss.
- 8 The answer is **D**. This is a transfer from PPE to investment property. The remeasurement to fair value is effected prior to the transfer, and recognised in accordance with LKAS 16 as a revaluation gain.





# Intangible Assets

## INTRODUCTION

Intangible assets are those non-current assets that have no substance, such as a brand or a licence. These items normally meet the definition of an asset, however strict recognition and measurement criteria are applied by LKAS 38, and this may mean that not all intangibles are recognised in the statement of financial position.

### Knowledge Component

#### 2 Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)

2.2	Level B	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.

CHAPTER CONTENTS	LEARNING OUTCOME
1 Definitions and recognition	2.2
2 Measurement	2.2
3 Research and development	2.2
4 Disclosure	2.2
5 Related interpretations	2.2

## LKAS 38 Learning objectives

- Define intangible assets.
- Analyse the conditions to be satisfied to recognise an intangible asset.
- Explain internally generated intangible assets, the research phase, the development phase and the cost of internally generated intangibles.
- Explain the measurement after recognition.
- Explain amortisation and impairment of intangible assets.
- Compute amortisation and impairment loss of intangible asset.
- Outline the disclosures to be made in respect of intangible assets.

### 1 Definitions and recognition



**Intangible assets are defined by LKAS 38 as non-monetary assets without physical substance.**

LKAS 38 *Intangible assets* defines an intangible asset and provides the recognition criteria and measurement bases to be applied to these assets.

#### 1.1 The objectives of the standard

- To establish the criteria for when an intangible asset may or should be **recognised**
- To specify how intangible assets should be **measured**
- To specify the **disclosure requirements** for intangible assets

## 1.2 Definition of an intangible asset

The definition of an intangible asset is a key aspect of the standard; both the definition and the recognition criteria must be met in order to recognise an intangible asset.



An **intangible asset** is an identifiable non-monetary asset without physical substance.

An **asset** is a resource:

- (a) Controlled by the entity as a result of events in the past
- (b) Something from which the entity expects future economic benefits to flow

**Monetary assets** are money held and assets to be received in fixed or determinable amounts of money.

Examples of items that might be considered as intangible assets include computer software, patents, copyrights, motion picture films, customer lists, franchises and fishing rights.

These items are not capitalised unless they meet the definition of an intangible in full, ie they are:

- (1) Identifiable;
- (2) Controlled by the entity as a result of past events; and
- (3) Expected to result in future economic benefits.

### 1.2.1 Intangible asset: must be identifiable

An asset is identifiable if either of the following applies.

- (a) It is separable, ie it is capable of being sold or transferred either as a single item or together with a related contract or identifiable asset or liability
- (b) It arises from contractual or other legal rights

Purchased intangible assets are usually identifiable; internally generated intangibles, such as customer lists, are also normally identifiable (although they may not meet other elements of the definition of intangibles).

Goodwill, whether purchased or internally generated, is not identifiable and is not an intangible asset within the scope of LKAS 38. It is, however, an intangible asset within the scope of SLFRS 3 *Business combinations* and is dealt with in detail in Chapter 21.

### 1.2.2 Intangible asset: must be controlled by the entity

Another element of the definition of an intangible asset is that it must be under the control of the entity as a result of a past event. The entity must therefore be able to enjoy the future economic benefits from the asset, and prevent the access of others to those benefits. A legally enforceable right is evidence of such control, but is not always a **necessary** condition.

- (a) Control over technical knowledge or know-how only exists if it is protected by a legal right such as a patent.
- (b) The skill of employees, arising out of the benefits of training costs, are most unlikely to be recognisable as an intangible asset, because an entity does not control the future actions of its staff.
- (c) Similarly, market share and customer loyalty cannot normally be intangible assets, since an entity cannot control the actions of its customers.

### 1.2.3 Intangible asset: must result in expected future economic benefits

An item can only be recognised as an intangible asset if economic benefits are expected to flow in the future from ownership of the asset. Economic benefits may come from the sale of products or services, or from a reduction in expenditures (cost savings).

## 1.3 Recognition criteria

An intangible asset is recognised if, and only if, both of the following criteria are met:

- (a) It is probable that the future economic benefits that are attributable to the asset will flow to the entity
- (b) The cost can be measured reliably

Management has to exercise its judgement in assessing the degree of certainty attached to the flow of economic benefits to the entity. External evidence is best.

The recognition criteria can be applied as follows:

- (a) If an intangible asset is **acquired separately**, it is normally because there is an expectation of future economic benefits. In addition, cost can usually be measured reliably as its purchase price (including incidental costs of purchase such as legal fees, and any costs incurred in getting the asset ready for use). Therefore, separately acquired intangibles are normally recognised in the financial statements.

- (b) When an intangible asset is acquired as part of a **business combination** (ie an acquisition or takeover), the cost of the intangible asset is its fair value at the date of the acquisition. Therefore, the intangible is recognised in the acquirer's financial statements. This is even the case where the acquiree did not previously recognise the asset.
- (c) **Internally generated** intangible assets may meet the recognition criteria; however, due to the judgement involved in this assessment, LKAS 38 required that all internally generated intangible assets are separately assessed as research and development (see Section 3).
- (d) **The standard specifically prohibits the recognition of any of the following as an intangible asset: internally generated brands, mastheads, publishing titles, customer lists and items similar in substance.**

## 2 Measurement



**An intangible asset is initially measured at cost and then under the cost or, in limited cases, the revaluation model.**

### 2.1 Initial measurement

An intangible asset is initially measured at cost.

- (a) The cost of **separately acquired** intangible assets includes:
  - Purchase price
  - Directly attributable costs of preparing the asset for its intended use (including professional fees and testing costs)
- (b) Intangible assets acquired as part of a **business combination** are initially measured at fair value at the date of the acquisition.
- (c) An **internally generated intangible asset** that meets the criteria to be recognised is measured at cost. This is discussed in more detail in Section 3.

#### 2.1.1 Exchanges of assets

If one intangible asset is exchanged for another, the cost of the intangible asset is measured at fair value unless either of the following applies.

- (a) The exchange transaction lacks commercial substance
- (b) The fair value of neither the asset received nor the asset given up can be measured reliably

Otherwise, its cost is measured at the carrying amount of the asset given up.

### 2.1.2 Intangibles acquired by way of government grant

LKAS 38 requires that intangible assets acquired by way of government grant are measured either at cost (which may be zero) or fair value.

## 2.2 Subsequent measurement

The standard allows two methods of valuation for intangible assets after they have been first recognised:

- (a) The **cost model** requires that an intangible asset is carried at its cost, less any accumulated amortisation and less any accumulated impairment losses.
- (b) The **revaluation model** allows an intangible asset to be carried at a revalued amount, which is its fair value at the date of revaluation, less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.

### 2.2.1 The cost model

Where the cost model is applied, the useful life of an intangible asset must be assessed and the asset amortised over this period. The useful life may be indefinite or finite.

#### Indefinite useful life

Where there is no foreseeable limit to the period over which the asset is expected to generate cash inflows, the life is indefinite. In this case:

- The asset is not amortised
- The useful life is reviewed annually to assess whether it remains indefinite
- The asset is tested for impairment annually in accordance with LKAS 36

#### Finite useful life

In determining useful life, the following factors should be considered: typical product life cycles; technical, technological, commercial or other types of obsolescence; the stability of the industry; expected actions by competitors; the level of maintenance expenditure required; and legal or similar limits on the use of the asset, such as the expiry dates of related leases.

The useful life of an intangible asset that arises from contractual or other legal rights should not exceed the period of the rights, but may be shorter depending on the period over which the entity expects to use the asset.

## Amortisation

The following points are relevant with regard to amortisation.

- (a) Amortisation should start when the asset is available for use.
- (b) Amortisation should cease at the earlier of the date that the asset is classified as held for sale in accordance with SLFRS 5 *Non-current assets held for sale and discontinued operations* and the date that the asset is derecognised.
- (c) The amortisation method used should reflect the pattern in which the asset's future economic benefits are consumed. If such a pattern cannot be predicted reliably, the straight line method should be used.
- (d) The amortisation charge for each period should normally be recognised in profit or loss.
- (e) The residual value of an intangible asset with a finite useful life is assumed to be zero unless a third party is committed to buying the intangible asset at the end of its useful life or unless there is an active market for that type of asset (so that its expected residual value can be measured) and it is probable that there will be a market for the asset at the end of its useful life.
- (f) The amortisation period and the amortisation method used for an intangible asset with a finite useful life should be reviewed at each financial year end.



### QUESTION

### Useful life

It may be difficult to establish the useful life of an intangible asset, and judgement will be needed.

### Required

**Discuss** how to determine the useful life of a **purchased** brand name.

### ANSWER

Factors to consider would include the following.

- (a) Legal protection of the brand name and the control of the entity over the (illegal) use by others of the brand name (ie control over pirating)
- (b) Age of the brand name
- (c) Status or position of the brand in its particular market
- (d) Ability of the management of the entity to manage the brand name and to measure activities that support the brand name (eg advertising and PR activities)
- (e) Stability and geographical spread of the market in which the branded products are sold

- (f) Pattern of benefits that the brand name is expected to generate over time
- (g) Intention of the entity to use and promote the brand name over time (as evidenced perhaps by a business plan in which there will be substantial expenditure to promote the brand name)

### 2.2.2 The revaluation model

The revaluation model can only be applied to assets for which fair value can be measured reliably by reference to an active market in that type of asset.



An **active market** is a market in which transactions for the asset take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

There will not usually be an active market in an intangible asset; therefore the revaluation model will usually not be available. For example, although copyrights, publishing rights and film rights can be sold, each has a unique sale value. In such cases, revaluation to fair value would be inappropriate. A fair value might be obtainable, however, for assets of which there is a large population of similar items, such as fishing rights or quotas or taxi-cab licences.

Where the revaluation model is applied:

- (a) The entire class of intangible assets of that type must be revalued at the same time (to prevent selective revaluations).
- (b) If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset should be carried at its cost less any accumulated amortisation and impairment losses.
- (c) Revaluations should be made with such regularity that the carrying amount does not differ from that which would be determined using fair value at the end of the reporting period.
- (d) Where an intangible asset is revalued upwards to a fair value, the amount of the revaluation should be credited directly to equity under the heading of a revaluation surplus (unless it is a reversal of a revaluation decrease that was previously charged against income, in which case the increase can be recognised as income).
- (e) The amortisation charge per annum will increase after an upwards revaluation, and the excess over historical cost amortisation can be transferred annually from the revaluation surplus to retained earnings.



- (f) Where the carrying amount of an intangible asset is revalued downwards, the amount of the downward revaluation should be charged as an expense against income (unless the asset has previously been revalued upwards, in which case the decrease is first charged against any previous revaluation surplus in respect of that asset).



### QUESTION

### Downward revaluation

An intangible asset is measured by a company at fair value. The asset was revalued by Rs. 40,000 in 20X3, and there is a revaluation surplus of Rs. 40,000 in the statement of financial position. At the end of 20X4, the asset is valued again, and a downward valuation of Rs. 50,000 is required.

### Required

**State** the accounting treatment for the downward revaluation.

### ANSWER

In this example, the downward revaluation of Rs. 50,000 is first set against the revaluation surplus of Rs. 40,000. The revaluation surplus will be reduced to Rs. nil and a charge of Rs. 100 made as an expense in 20X4.

## 2.3 Disposals/retirements of intangible assets

An intangible asset is derecognised from the statement of financial position when it is disposed of or when there is no further expected economic benefit from its future use.

On disposal, the gain or loss arising from the difference between the net disposal proceeds and the carrying amount of the asset should be taken to profit or loss as a gain or loss on disposal (ie treated as income or expense).

## 3 Research and development



**Research costs are recognised in profit or loss; development costs are recognised as an asset if they meet certain criteria.**

LKAS 38 assesses all internally generated intangible assets by classifying them as either research or development.

### 3.1 Definitions



**Research** is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

**Development** is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

#### Examples of research costs

- (a) Activities aimed at obtaining new knowledge
- (b) The search for, evaluation and final selection of, applications of research findings or other knowledge
- (c) The search for alternatives for materials, devices, products, processes, systems or services
- (d) The formulation, design evaluation and final selection of possible alternatives for new or improved materials, devices, products, systems or services

#### Examples of development costs

- (a) The design, construction and testing of pre-production or pre-use prototypes and models
- (b) The design of tools, jigs, moulds and dies involving new technology
- (c) The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production
- (d) The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services

### 3.2 Accounting treatment

**Research activities** by definition do not meet the criteria for recognition under LKAS 38. This is because, at the research stage of a project, it cannot be certain that future economic benefits will probably flow to the entity from the project. There is too much uncertainty about the likely success or otherwise of the project. **Research costs should therefore be written off as an expense as they are incurred.**

**Development costs** may qualify for recognition as intangible assets provided that the following strict criteria can be demonstrated.

- (a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.
- (b) Its intention to complete the intangible asset and use or sell it.
- (c) Its ability to use or sell the intangible asset.
- (d) How the intangible asset will generate probable future economic benefits. Among other things, the entity should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
- (e) Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

### 3.3 Initial measurement of an internally generated intangible asset

The costs allocated to an internally generated intangible asset should be only costs that can be directly attributed or allocated on a reasonable and consistent basis to creating, producing or preparing the asset for its intended use. The principles underlying the costs that may or may not be included are similar to those for other non-current assets and inventory.

The cost of an internally generated intangible asset is the sum of the expenditure incurred from the date when the intangible asset first meets the recognition criteria. If, as often happens, considerable costs have already been recognised as expenses before management could demonstrate that the criteria have been met, this earlier expenditure should not be retrospectively recognised at a later date as part of the cost of an intangible asset.

### 3.4 Subsequent measurement of an internally generated intangible asset

Subsequent to initial recognition, either the cost model or, where available, the revaluation model is applied as described in Section 2.



#### QUESTION

#### Measurement

Colombo Manufacturing PLC is developing a new production process. During 20X3, expenditure incurred was Rs. 1,000,000, of which Rs. 900,000 was incurred before 1 December 20X3 and Rs. 100,000 between 1 December 20X3 and 31 December 20X3. Colombo Manufacturing can demonstrate that, at 1 December 20X3, the production process met the criteria for recognition as an intangible

asset. The recoverable amount of the know-how embodied in the process is estimated to be Rs. 500,000.

### Required

**Explain** how the expenditure should be treated.

### ANSWER

At the end of 20X3, the production process is recognised as an intangible asset at a cost of Rs. 100,000. This is the expenditure incurred since the date when the recognition criteria were met, that is 1 December 20X3. The Rs. 900,000 expenditure incurred before 1 December 20X3 is expensed, because the recognition criteria were not met. It will never form part of the cost of the production process recognised in the statement of financial position.



### QUESTION

### Internally generated intangible assets

Liyanage Textiles PLC has incurred the following costs in the year ended 31 December 20X5.

- (1) Rs. 500,000 was spent on investigating properties of certain substances with the aim of developing a fire-resistant coating for fabrics. The company expects to develop and test this coating over the next three years with a view to commercial sales thereafter.
- (2) Rs. 750,000 was spent on testing a computerised design programme developed by the company's IT department for internal use. This programme will be used by the company from 20X6 and is expected to reduce costs by 30%.

### Required

**State** how these costs are treated in the financial statements of Liyanage Textiles PLC.

### ANSWER

- (1) The project is at the research phase: investigations have been performed into the properties of substances, however as yet there is no product being developed for use or commercial sale. Therefore, the Rs. 500,000 is recognised as an expense.
- (2) The Rs. 750,000 should be classified as development costs: the programme is at an advanced stage and is due to be in place within a year. It will result in

economic benefits in the form of cost savings. The Rs. 750,000 should therefore be capitalised as an intangible asset.

## 4 Disclosure



**LKAS 38 requires a number of general disclosures together with additional disclosures about research and development expenditure and intangible assets measured using the revaluation model.**

### 4.1 General disclosures

An entity must disclose the following for each class of intangible assets, distinguishing between those that are internally generated and those that are not.

- (a) Whether useful lives are indefinite, and where this is not the case, the amortisation rates and methods used
- (b) The gross carrying amount and accumulated amortisation at the start and end of the period
- (c) The line item in the statement of profit or loss in which amortisation is included
- (d) A reconciliation of the carrying amount at the start and end of the period showing additions, assets classified as held for sale, revaluation increases and decreases, impairment losses recognised and reversed, amortisation, exchange differences and other changes

In addition, the following must be disclosed.

- (a) The carrying amount of any intangible asset with an indefinite useful life and the reasons supporting the assessment of an indefinite life
- (b) A description, the carrying amount and remaining amortisation period of any material intangible asset
- (c) For intangible assets acquired by way of government grant and recognised initially at fair value:
  - The fair value initially recognised
  - Their carrying amount
  - Whether the cost or revaluation model is applied
- (d) The existence and carrying amounts of intangible assets with restricted title/pledged as security for liabilities

- (e) The amount of contractual commitments for the acquisition of intangible assets

## 4.2 Research and development expenditure

An entity should disclose the aggregate amount of research and development expenditure recognised as an expense in the period.

## 4.3 Revaluation model disclosures

If intangible assets are accounted for at revalued amounts, the following must be disclosed:

- (a) By class of intangible assets:
- The effective date of the revaluation
  - The carrying amount of revalued intangible assets
  - The carrying amount that would have been recognised if the cost model were applied
- (b) The amount of the revaluation surplus that relates to intangible assets at the start and end of the period indicating changes in the period and restrictions on the distribution of the balance to shareholders.

## 5 Related interpretations



### SIC 32 deals with accounting for the costs of setting up a website.

When a company sets up a website (which may be for internal or external use), it may incur internal expenditure at the following stages of development.

- (1) Planning stage: planning the website
- (2) Application and infrastructure development stage: obtaining a domain name and developing hardware and operating software
- (3) Graphical design stage: designing the web pages
- (4) Content development stage: developing content

When the website has been set up, further expenditure will be incurred on maintaining and updating the site (the operating stage).

SIC 32 *Intangible assets – website costs* addresses the issue of how to account for the internal costs of developing and operating a website and in particular whether the website is an intangible asset.

Note that certain associated costs are outside the scope of the Interpretation:

- Hardware such as web servers are property, plant and equipment within the scope of LKAS 16.
- Hosting costs are an expense accounted for as service is received.

## 5.1 Accounting treatment

SIC 32 states that a website is recognised as an intangible asset if:

- (a) It is probable that future economic benefits will flow to the entity
- (b) The cost of the asset can be measured reliably
- (c) The recognition criteria associated with development costs are met, ie:
  - Completion of the intangible asset is technically feasible
  - The entity intends to complete the website and use it
  - The entity can use the website
  - The entity can demonstrate how the website will generate economic benefits
  - There are adequate resources to complete the website
  - Expenditure attributable to the website during development can be measured reliably

In respect of the requirement to demonstrate how the website will generate economic benefits, SIC 32 states:

- (a) The requirement is met when a website is capable of generating revenue by allowing online orders to be placed
- (b) The requirement is not met when a website is developed solely as an advertising or promotional tool

Therefore, the costs of developing a website that is not capable of taking orders and is simply an advertising tool are recognised as an expense.

### 5.1.1 Application to development stages

The application of the SIC 32 recognition criteria to the stages of development and operation of a website can be summarised as follows.

Planning stage	Expenditure recognised as an expense when incurred.
Application and infrastructure development stage	Where content is developed for purposes other than to advertise products or services, expenditure is recognised as an intangible when the expenditure can be attributed to preparing the website for its intended use.
Graphical design stage	
Content development stage	
	To the extent that content is developed to advertise products or services (eg photographing products), associated costs are expensed when services are received.
Operating stage	Expenditure recognised as an expense unless it meets the LKAS 38 definition and recognition criteria for an intangible asset.

### 5.1.2 Subsequent treatment of website intangible

After initial recognition, a website intangible asset is measured in accordance with LKAS 38. The useful life of the asset should be short.



**CHAPTER ROUNDUP**

- ↪ **Intangible assets are defined by LKAS 38 as non-monetary assets without physical substance.**
- ↪ **An intangible asset is initially measured at cost and then under the cost or, in limited cases, the revaluation model.**
- ↪ **Research costs are recognised in profit or loss; development costs are recognised as an asset if they meet certain criteria.**
- ↪ **LKAS 38 requires a number of general disclosures together with additional disclosures about research and development expenditure and intangible assets measured using the revaluation model.**
- ↪ **SIC 32 deals with accounting for the costs of setting up a website.**


**PROGRESS TEST**

- 1 What makes an intangible asset identifiable?
- 2 How is an intangible asset initially acquired in a business combination measured?
- 3 Under what circumstances can an intangible asset be revalued?
- 4 How is an intangible asset with an indefinite useful life accounted for?
- 5 What distinguishes the research and development phases of a project?
- 6 A company had deferred development expenditure of Rs. 1,200,000 relating to the development of a new product at 31 December 20X2. Further development costs of Rs. 300,000 plus advertising costs of Rs. 100,000 were incurred in the first six months of 20X3. The product was launched on 1 July 20X3 and is expected to result in sales for 10 years from this date.

What is the amortisation charge in the year ended 31 December 20X3?

- A Rs. 150,000
  - B Rs. 135,000
  - C Rs. 80,000
  - D Rs. 75,000
- 7 A company owns 20 10-year licences to operate taxis which it bought at a cost of Rs. 30,000 each at the start of 20X3. There is an active market in these licences, and at 31 December 20X3 the fair value of one licence is Rs. 35,000. The company adopts the revaluation model at this date. How is the increase in value accounted for?
    - A Rs. 50,000 gain in profit or loss
    - B Rs. 50,000 other comprehensive income
    - C Rs. 80,000 gain in profit or loss
    - D Rs. 80,000 other comprehensive income
  - 8 A company owns an intangible asset that cost Rs. 340,000 including Rs. 25,000 professional fees. The asset is part of an active market and has an indefinite life. Two years after acquisition, the asset was revalued to Rs. 380,000. As a result of developments in the market, the asset now has a fair value of Rs. 335,000. How is this downwards revaluation recorded?
    - A DEBIT profit or loss Rs. 45,000
    - B DEBIT revaluation surplus Rs. 45,000
    - C DEBIT revaluation surplus Rs. 15,000, DEBIT profit or loss Rs. 25,000
    - D DEBIT revaluation surplus Rs. 40,000, DEBIT profit or loss Rs. 5,000

## ANSWERS TO PROGRESS TEST

- 1 (a) It is capable of separate sale or sale together with a related contract, identifiable asset or liability, or  
(b) It arises from contractual or other legal rights
- 2 At fair value
- 3 Only when there is an active market in that asset
- 4 It is not amortised, but it should be tested for impairment annually, and the useful life should be reviewed annually.
- 5 Research is investigation to gain new knowledge; development is application of research in order to start commercial production or use. Therefore, proximity to market and the possibility of achieving economic benefits from a project distinguishes the two phases.
- 6 The answer is **D**. Advertising costs are not development costs; these are recognised in profit or loss as incurred.  
Amortisation starts when commercial production starts, ie on 1 July 20X3.  
Therefore, the amortisation charge is  $(\text{Rs. } 1,200,000 + \text{Rs. } 300,000)/10 \text{ years} \times 6/12\text{m} = \text{Rs. } 75,000$ .
- 7 The answer is **D**. The licences are for 10 years and therefore at 31 December 20X3 each has a carrying amount of  $\text{Rs. } 30,000 \times 9/10 \text{ years} = \text{Rs. } 27,000$ .  
The revaluation increase is therefore  $(\text{Rs. } 35,000 - \text{Rs. } 27,000) \times 10 = \text{Rs. } 80,000$ .  
This is recognised as other comprehensive income.
- 8 The answer is **C**. The asset is initially recorded at cost including professional fees of Rs. 365,000.  
The subsequent upwards revaluation of Rs. 15,000 is credited to the revaluation surplus.  
The Rs. 45,000 downwards revaluation is first debited to the existing revaluation surplus and thereafter to profit or loss.



# Impairment

## INTRODUCTION

LKAS 36 deals with the impairment of assets. An impairment is a fall in value; in order that financial statements remain relevant, it is important that assets are not recorded at a carrying amount above their value to the company (either through continued use or sale).

Knowledge Component			
2	Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)		
2.2	Level B	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.

CHAPTER CONTENTS	LEARNING OUTCOME
1 Introduction	2.2
2 Identification of impairment	2.2
3 The impairment test	2.2
4 Accounting for impairment	2.2
5 Cash-generating units	2.2
6 Reversals of impairments	2.2
7 Disclosure	2.2

## LKAS 36 Learning objectives

- Discuss what an impairment is.
- Explain the conditions of impairment (how to identify an asset that may be impaired).
- Assess the recoverable amount of an asset (value in use and fair value less costs to sell).
- Explain the basis to be used to estimate future cash flows in determining value in use.
- Discuss how to measure the recoverable amount of an intangible asset with an indefinite useful life.
- Assess the recoverable amount and carrying amount of a cash-generating unit.
- Compute the impairment loss of an individual asset and a cash-generating unit.
- Explain the reversing of an impairment loss of an individual asset, goodwill and a cash-generating unit.
- Compute the impairment loss to be reversed for an individual asset, goodwill and a cash-generating unit.
- Outline the disclosures to be made in respect of impairment of assets.

# 1 Introduction



**Impairment is determined by comparing the carrying amount of the asset with its recoverable amount. This is the higher of its fair value less costs of disposal and its value in use.**

There is an established principle that assets should not be carried at above their recoverable amount. An entity should write down the carrying amount of an asset to its recoverable amount if the carrying amount of an asset is not recoverable in full either through continued use or sale. LKAS 36 *Impairment of assets* puts in place a detailed methodology for carrying out impairment reviews and related accounting treatments and disclosures.

The main accounting issues to consider are as follows.

- (a) How is it possible to **identify when** an impairment loss may have occurred?
- (b) How should the **recoverable amount** of the asset be measured?
- (c) How should an 'impairment loss' be **recognised in the accounts**?

## 1.1 Scope of LKAS 36

LKAS 36 applies to all tangible, intangible and financial assets except for:

- Inventories
- Assets arising from construction contracts
- Deferred tax assets
- Assets arising under LKAS 19 *Employee benefits*
- Financial assets within the scope of LKAS 32 *Financial instruments: presentation*
- Investment property measured at fair value (LKAS 40)
- Biological assets measured at fair value less costs to sell (LKAS 41)
- Non-current assets held for sale, which are dealt with under SLFRS 5 *Non-current assets held for sale and discontinued operations*

## 1.2 Definitions

LKAS 36 provides the following definitions.



An **impairment loss** is the amount by which the carrying amount of an asset or cash-generating unit exceeds its recoverable amount.

**Carrying amount** is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

**Recoverable amount** is the higher of an asset's fair value less costs of disposal and its value in use.

**Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Costs of disposal** are incremental costs directly attributable to the disposal of an asset or cash-generating unit excluding finance costs and income tax expense.

**Value in use** is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

## 2 Identification of impairment



**An entity should assess at the end of each reporting period whether there are any indications of impairment to any assets. Indications may be internal or external.**

An entity should assess at the end of each reporting period whether there are any indications of impairment to any assets. The concept of **materiality** applies, and only material impairment needs to be identified.

If there are indications of possible impairment, the entity is required to conduct an impairment test (see Section 3). If there are no indications of impairment, an impairment test is not required except for those assets listed in Section 2.3.

The indications of a possible impairment of assets provided by LKAS 36 include both external and internal sources of information. The standard is clear that the list provided is not exhaustive.

### 2.1 External sources of information

External sources of information may include:

- (a) A fall in the asset's market value that is more significant than would normally be expected from passage of time over normal use.
- (b) A significant change in the technological, market, legal or economic environment of the business in which the assets are employed.



- (c) An increase in market interest rates or market rates of return on investments likely to affect the discount rate used in calculating value in use.
- (d) The carrying amount of the entity's net assets being more than its market capitalisation.

## 2.2 Internal sources of information

Internal sources of information may include:

- (a) Evidence of obsolescence or physical damage of an asset.
- (b) Adverse changes in the use to which the asset is put, eg the asset becoming idle, plans to dispose of an asset early or plans to discontinue the part of a business that uses the asset.
- (c) Worse than expected economic performance of the asset.
- (d) Evidence from internal reporting such as:
  - Cash flows for operating/maintaining the asset that are significantly higher than originally budgeted
  - Net cash flows or operating profit/loss that is significantly worse than budgeted
  - A significant decline in budgeted net cash flows or operating profit flowing from the asset
  - Operating losses or net cash outflows when current periods are aggregated with budgeted amounts for the future

## 2.3 Annual testing

Even if there are no indications of impairment, the following assets must always be tested for impairment annually.

- (a) An intangible asset with an indefinite useful life
- (b) An intangible asset that is not yet available for use
- (c) Goodwill acquired in a business combination

Impairment testing of intangible assets must take place at the same time every year; however, there is no need for this to be at the reporting date. In the year in which an intangible asset was initially recognised, it must be tested for impairment before the end of that year.

### 3 The impairment test



Testing for impairment involves determining an asset's recoverable amount and comparing this with the asset's carrying amount.

#### 3.1 Calculation of impairment loss

An impairment loss arises where carrying amount exceeds recoverable amount, which is the higher of value in use and fair value less costs of disposal. In this case, carrying amount is written down to recoverable amount and the write down is recognised as an impairment loss.

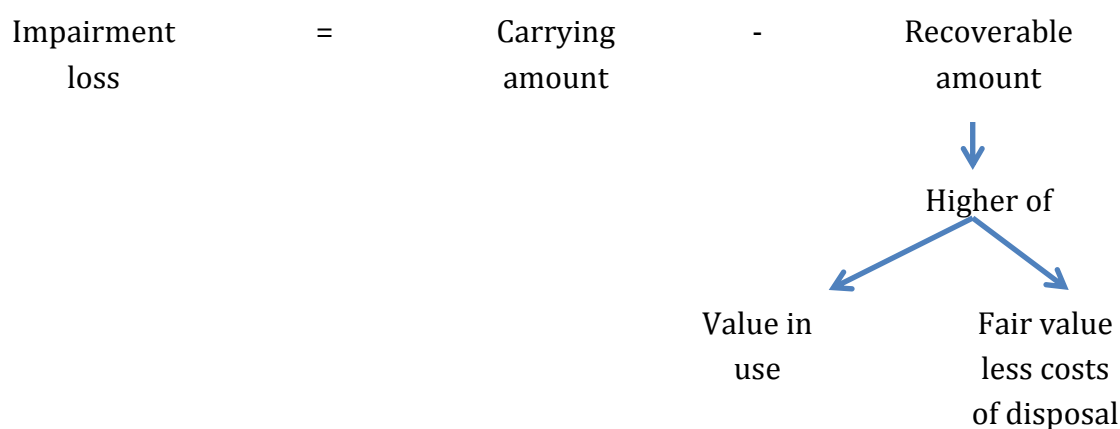


Figure 8.1

Therefore testing for impairment involves establishing recoverable amount.

As recoverable amount is the higher of value in use and fair value less costs of disposal, if either of these amounts exceeds an asset's carrying amount, the asset is not impaired and there is no need to determine the other amount.



#### QUESTION

#### Impairment loss

In each of the following situations, **identify** whether the asset is impaired.

- (1) The carrying amount of a machine is Rs. 69,500. Its value in use is Rs. 68,500 and its fair value is Rs. 70,000. Costs of disposal are Rs. 600.
- (2) The carrying amount of a property is Rs. 4.5m. The property could be sold on the open market for an estimated Rs. 5m subject to 10% agency fees. The value in use has been estimated at Rs. 4.4m.

## ANSWER

- (1) Value in use is Rs. 68,500; fair value less costs of disposal is Rs. 69,400. Recoverable amount is the higher of these, therefore Rs. 69,400. As this is less than carrying amount, the machine is impaired and an impairment loss of Rs. 100 arises.
- (2) Value in use is Rs. 4.4m; fair value less costs of disposal is Rs. 4.5m (Rs. 5m × 90%). Recoverable amount is therefore Rs. 4.5m. As this is equal to carrying amount, there is no impairment.

### 3.2 Measuring fair value less costs of disposal

Fair value is established in accordance with the requirements of SLFRS 13 *Fair value measurement*. It is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

LKAS 36 provides no guidance on establishing fair value; however it does clarify that costs of disposal may include legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale. They do not, however, include termination benefits, nor costs associated with reducing or reorganising a business following the disposal of an asset.

### 3.3 Measuring value in use

Value in use is the present value of the future cash flows expected to be generated by an asset. It must reflect:

- (a) An estimate of the future cash flows the entity expects to derive from the asset
- (b) Expectations about possible variations in the amount and timing of future cash flows
- (c) The time value of money
- (d) The price for bearing the uncertainty inherent in the asset
- (e) Other factors that would be reflected in pricing future cash flows from the asset

Estimating value in use involves estimating cash flows to be derived from use (and disposal) of the asset and applying an appropriate discount rate.

### 3.3.1 Estimate of cash flows

The standard requires that:

- (a) Cash flow projections are based on 'reasonable and supportable' assumptions.
- (b) Projections of cash flows, normally up to a maximum period of five years, are based on the most recent budgets or financial forecasts.
- (c) A steady or declining growth rate for each subsequent year (unless a rising growth rate can be justified) is used in extrapolating short-term projections of cash flows beyond this period. Unless a higher growth rate can be justified, the long-term growth rate employed should not be higher than the average long-term growth rate for the product, market, industry or country.

Cash flows should include:

- Projected cash inflows from continuing use of the asset
- Projected cash outflows necessary to generate these cash inflows
- Net cash flows from the disposal of the asset at the end of its life

They should not include:

- Cash flows associated with a future restructuring to which an entity is not committed
- Cash flows associated with improving the asset's performance
- Cash flows from financing activities
- Income tax receipts or payments

### 3.3.2 Discount rate

The discount rate should be a current pre-tax rate (or rates) that reflects:

- The current assessment of the time value of money
- The risks specific to the asset

## 3.4 Impairment testing of an intangible asset with an indefinite useful life

An intangible asset with an indefinite useful life must be tested for impairment annually, regardless of whether there are indications of impairment.

As this requirement can be onerous to apply, LKAS 36 allows an entity to use the most recent detailed calculation of recoverable amount in a preceding period for the current period where:

- (a) If the asset is tested for impairment as part of a cash-generating unit, the assets and liabilities making up that unit have not changed significantly since the most recent recoverable amount calculation (see Section 5)
- (b) The most recently calculated recoverable amount exceeded the asset's carrying amount by a substantial margin
- (c) Events and circumstances that have occurred since the most recent recoverable amount calculation have been analysed and there is only a remote likelihood that recoverable amount, if determined now, would be less than the asset's carrying amount

## 4 Accounting for impairment



**An impairment loss is recognised in profit or loss in the period when it arises.**

### 4.1 Recognition of impairment loss

If the recoverable amount of an asset is less than its carrying amount, the asset is impaired and an impairment loss should be recognised. Impairment losses are normally recognised in profit or loss as they arise; however, where an impairment loss arises on a revalued asset, the impairment is treated as a revaluation decrease and first charged to the revaluation surplus.



#### 4.1.1 Example: recognition of impairment loss

Fernando Property (Pvt) Ltd acquired a property on 1 January 20X4 at a cost of Rs. 8m and commenced depreciation over a 50-year useful life from this date. The company applied the LKAS 16 revaluation model for the subsequent accounting of the property, and revalued it for the first time to Rs. 8,544,000 at 31 December 20X5, continuing to depreciate it over the original term. During 20X6 there was a commercial property crash, and as a result the recoverable amount of the property fell to Rs. 7.4m at 31 December 20X6.

Fernando Property do not make an annual reserves transfer in respect of revalued property.

#### **Required**

**Demonstrate** how the impairment at 31 December 20X6 is accounted for.

**Solution**

	Rs'000
Cost at 1 January 20X4	8,000
Depreciation 20X4 (8m/50)	(160)
Depreciation 20X5	<u>(160)</u>
Carrying amount 31 December 20X5	7,680
Revaluation surplus	<u>864</u>
Revalued amount 31 December 20X5	8,544
Depreciation 20X6 (8,544/48)	<u>(178)</u>
Carrying amount 31 December 20X6	8,366
Impairment loss	<u>(966)</u>
Impaired carrying amount 31 December 20X6	7,400

The Rs. 966,000 impairment loss is recognised as follows.

- (1) Rs. 864,000 in other comprehensive income to reduce the previously recognised revaluation surplus to nil
- (2) Rs. 102,000 in profit or loss

**QUESTION****Recognition of impairment loss**

A company that extracts natural gas and oil has a drilling platform in the Caspian Sea. It is required by legislation of the country concerned to remove and dismantle the platform at the end of its useful life. Accordingly, the company has included an amount in its accounts for removal and dismantling costs, and is depreciating this amount over the platform's expected life.

The company is carrying out an exercise to establish whether there has been an impairment of the platform.

- (a) Its carrying amount in the statement of financial position is Rs. 3m.
- (b) The company has received an offer of Rs. 2.8m for the platform from another oil company. The bidder would take over the responsibility (and costs) for dismantling and removing the platform at the end of its life.
- (c) The present value of the estimated cash flows from the platform's continued use is Rs. 3.3m (before adjusting for dismantling costs).
- (d) The carrying amount in the statement of financial position for the provision for dismantling and removal is currently Rs. 0.6m.

**Required**

**Calculate** the carrying amount of the drilling platform in the statement of financial position, and **demonstrate** how the impairment loss, if any, is accounted for.

**ANSWER**

Fair value less costs of disposal	=	Rs. 2.8m
Value in use	=	PV of cash flows from use less the carrying amount of the provision/liability = Rs. 3.3m – Rs. 0.6m = Rs. 2.7m
Recoverable amount	=	Higher of these two amounts Rs. 2.8m
Carrying amount	=	Rs. 3m
Impairment loss	=	Rs. 0.2m

The loss is recognised by:

DEBIT	Profit or loss	Rs. 0.2m
CREDIT	Drilling platform	Rs. 0.2m

**4.2 Subsequent accounting for an impaired asset**

Subsequent to impairment, an asset continues to be depreciated, with the recoverable amount written off over the remaining useful life.

The impairment testing rules of LKAS 36 are applied to all assets including those previously impaired and therefore further impairment tests are carried out at any later date where there are indications of impairment.

**5 Cash-generating units**

**Where the recoverable amount of an individual asset cannot be determined, it should be tested for impairment as part of the cash-generating unit to which it belongs.**

Recoverable amount is determined for an individual asset as far as possible; however, where an asset does not generate cash flows that are independent of other assets, then recoverable amount must be determined for the cash-generating unit (CGU) to which the asset belongs.

A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. They should be identified consistently from period to period for the same asset, unless a change is justified.



## **5.1 Example: cash-generating unit**

A mining company owns a private railway to support its mining activities. The railway could only be sold for scrap value and does not generate cash flows that are largely independent of the cash inflows from the other assets of the mine.

In this case, it is not possible to estimate the recoverable amount of the private railway because its value in use cannot be determined and is unlikely to be similar to scrap value. Therefore the entity estimates the recoverable amount of the CGU to which the private railway belongs (the mine) as a whole.

## **5.2 Instances in which determining a CGU is unnecessary**

There are two instances where the CGU of an asset does not have to be considered in order to determine whether that asset is impaired.

- (1) Where the asset's fair value less costs of disposal exceeds its carrying amount (ie there is no impairment), or
- (2) Where the asset's value in use can be estimated to be close to its fair value less costs of disposal and fair value less costs of disposal can be measured

## **5.3 Allocating assets to a CGU**

An impairment loss in a CGU arises where its carrying amount exceeds its recoverable amount. The recoverable amount of a CGU is determined in the same way as the recoverable amount of an individual asset.

The carrying amount of a CGU is determined on a basis consistent with the way in which the recoverable amount of the CGU is determined, ie it includes those assets that will generate cash flows that are used in determining the CGU's value in use.

### **5.3.1 Corporate assets**

Corporate assets are those such as a head office that are used by more than one CGU. A portion of these should be allocated to the CGUs on a reasonable and consistent basis when determining the CGU's carrying amount, eg on the basis of the carrying amounts of the other non-current assets of each CGU.

### **5.3.2 Goodwill**

Goodwill acquired in a business combination does not generate cash flows independently of other assets. It must be allocated to each of the acquirer's cash-generating units (or groups of cash-generating units) that are expected to



benefit from the synergies of the combination. Each unit to which the goodwill is so allocated should:

- (a) Represent the lowest level within the entity at which the goodwill is monitored for internal management purposes
- (b) Not be larger than a reporting segment determined in accordance with SLFRS 8 *Operating segments*

It may be impracticable to complete the allocation of goodwill before the first reporting date after a business combination, particularly if the acquirer is accounting for the combination for the first time using provisional values. The initial allocation of goodwill must be completed before the end of the first reporting period after the acquisition date.

## 5.4 Accounting for an impairment loss in a CGU

An impairment loss should be recognised for a CGU if (and only if) the recoverable amount of the CGU is less than the carrying amount in the statement of financial position. When an impairment loss is recognised for a cash-generating unit, the loss should be allocated between the assets in the unit in the following order.

- (a) First, to any assets that are obviously damaged or destroyed
- (b) Next, to the goodwill allocated to the cash generating unit
- (c) Then, to all other assets in the cash-generating unit, on a pro-rata basis

In allocating an impairment loss, the carrying amount of an asset should not be reduced below the highest of:

- (a) Its fair value less costs of disposal
- (b) Its value in use (if determinable)
- (c) Zero



### 5.4.1 Example: accounting for an impairment loss in a CGU

A company has acquired another business for Rs. 4.5m: tangible assets are valued at Rs. 4m and goodwill at Rs. 0.5m.

An asset with a carrying value of Rs. 1m is destroyed in a terrorist attack. The asset was not insured. The loss of the asset, without insurance, has prompted the company to assess whether there has been an impairment of assets in the acquired business and what the amount of any such loss is.

The recoverable amount of the business (a single cash-generating unit) is measured as Rs. 3.1m.

**Required**

**Explain** how the impairment should be recognised.

**Solution**

There has been an impairment loss of Rs. 1.4m (Rs. 4.5m – Rs. 3.1m).

The impairment loss will be recognised in profit or loss. The loss will be allocated between the assets in the CGU as follows.

- (a) A loss of Rs. 1m is attributed directly to the uninsured asset that has been destroyed.
- (b) The remaining loss of Rs. 0.4m is allocated to goodwill.

The carrying amount of the assets will now be Rs. 3m for tangible assets and Rs. 0.1m for goodwill.

**QUESTION****Recognition of impairment loss in CGU**

A cash-generating unit comprises the following:

	Rs Mn
Building	30
Plant and equipment	6
Goodwill	10
Current assets	<u>20</u>
	<u>66</u>

Following a recession, an impairment review has estimated the value in use of the cash-generating unit to be Rs. 50m and the fair value less costs of disposal to be Rs. 48m.

**Required**

**Demonstrate** how the impairment loss is allocated.

**ANSWER**

The recoverable amount of the CGU is Rs. 50m; therefore, there is an impairment loss of Rs. 16m. The loss is applied first against the goodwill and then against the tangible non-current assets on a pro-rata basis. After writing off the goodwill, the balance to be allocated is Rs. 6m. This is pro-rated over the total of Rs. 36m for the remaining non-current assets at a rate of Rs. 1m per Rs. 6m.

	<i>Carrying amount</i>	<i>Impairment loss</i>	<i>Carrying amount post- impairment</i>
	Rs Mn	Rs Mn	Rs Mn
Building	30	(5)	25
Plant and equipment	6	(1)	5
Goodwill	10	(10)	–
Current assets	<u>20</u>	<u>–</u>	<u>20</u>
	<u>66</u>	<u>(16)</u>	<u>50</u>

Note that current assets are outside the scope of LKAS 36 and therefore no loss is allocated to them.

## 6 Reversals of impairment



**In some circumstances, a previously recognised impairment loss may be reversed.**

### 6.1 Individual assets

Where impairment testing is carried out on a previously impaired asset, the recoverable amount may be higher than the asset's carrying amount. In this case, the previously recognised impairment loss is reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised.

The reversal of an impairment loss is recognised by:

DEBIT     Asset's carrying amount  
CREDIT   Profit or loss

The new carrying amount after the reversal cannot be higher than the carrying amount would have been (after the relevant depreciation) if the original impairment had not occurred.

Subsequent depreciation is based on the new carrying amount, estimated residual value and estimated useful life.

### 6.2 Cash-generating units

An impairment loss for goodwill is not reversed subsequent to recognition.

**QUESTION****Reversal of an impairment loss**

A cash-generating unit comprising assets and associated purchased goodwill becomes impaired because the product it makes is overtaken by a technologically more advanced model produced by a competitor. The recoverable amount of the cash-generating unit falls to Rs. 80m, resulting in an impairment loss of Rs. 60m, allocated as follows.

	<i>Carrying amount before impairment</i>	<i>Carrying amount after impairment</i>
	Rs Mn	Rs Mn
Goodwill	40	–
Current assets	20	20
Tangible non-current assets (market value Rs. 60m)	<u>80</u>	<u>60</u>
Total	<u>140</u>	<u>80</u>

After two years, the entity makes a technological breakthrough of its own. At this time the carrying amount of the tangible non-current assets of the CGU is Rs. 48m and the carrying amount of current assets is Rs. 25m and the recoverable amount of the cash-generating unit increases to Rs. 90m. The carrying amount of the tangible non-current assets had the impairment not occurred would have been Rs. 64m.

**Required**

**Calculate** the reversal of the impairment loss.

**ANSWER**

LKAS 36 prohibits recognition of the reversal of the impairment loss in relation to the goodwill.

The reversal of the impairment loss is recognised to the extent that it increases the carrying amount of the tangible non-current assets to the carrying amount had the impairment not taken place.

Therefore, Rs. 16m of the impairment loss is reversed and the tangible non-current assets written back to Rs. 64m.

The carrying amount of the CGU therefore becomes Rs. 89m (Rs. 25m + Rs. 64m).

## 7 Disclosure



### **LKAS 36 has extensive disclosure requirements.**

LKAS 36 requires that the following is disclosed in respect of impairments.

- (a) The amount of impairment losses and reversals recognised in profit or loss in the period and the line item where they are recognised.
- (b) The amount of impairment losses and reversals recognised in other comprehensive income in the period.

In addition, the following is disclosed for individual assets or CGUs for which a material impairment loss is recognised or reversed in the period:

- (a) Events and circumstances leading to recognition of the loss or reversal
- (b) The amount of loss or reversal recognised
- (c) Details of the individual asset or CGU
- (d) The recoverable amount and whether that is value in use or fair value less costs of disposal
- (e) Details of how fair value is determined (where that is recoverable amount)
- (f) Details of the discount rate used in value in use (where that is recoverable amount)

For the aggregate impairment losses and the aggregate reversals of impairment losses recognised during the period that are not material:

- (a) The main classes of assets affected by impairment losses and reversals
- (b) The main events and circumstances that led to the recognition of these impairment losses and reversals

In addition, detailed disclosure is required in respect of estimated used to measure recoverable amounts of CGUs containing goodwill or intangible assets with indefinite useful lives.

**CHAPTER ROUNDUP**

- ↪ **Impairment is determined by comparing the carrying amount of the asset with its recoverable amount. This is the higher of its fair value less costs of disposal and its value in use.**
- ↪ **An entity should assess at the end of each reporting period whether there are any indications of impairment to any assets. Indications may be internal or external.**
- ↪ **Testing for impairment involves determining an asset's recoverable amount and comparing this with the asset's carrying amount.**
- ↪ **An impairment loss is recognised in profit or loss in the period when it arises.**
- ↪ **Where the recoverable amount of an individual asset cannot be determined, it should be tested for impairment as part of the cash-generating unit to which it belongs.**
- ↪ **In some circumstances, a previously recognised impairment loss may be reversed.**
- ↪ **LKAS 36 has extensive disclosure requirements.**


**PROGRESS TEST**

- 1 How is recoverable amount calculated?
- 2 How is an impairment loss in relation to a previously revalued asset recognised?
- 3 In what order is an impairment loss allocated to the assets of a CGU?
- 4 In what circumstances is an impairment loss reversed?
- 5 To what extent can an impairment loss be reversed in relation to goodwill and other assets within the scope of LKAS 36?
- 6 A company acquired a property on 1 January 20X2 at a cost of Rs. 10m and began depreciating it over 50 years immediately. On 31 December 20X7, the company adopted a policy of revaluation and the property was revalued to Rs. 9.9m. It continued to be depreciated over the remainder of the original useful life. On 31 December 20X8, the property was tested for impairment and found to have a recoverable amount of 9.4m. What amount is recognised in profit or loss in respect of the impairment in the year ended 31 December 20X8?
  - A Nil
  - B Rs. 275,000
  - C Rs. 302,000
  - D Rs. 500,000
- 7 A CGU includes the following assets.
 

Goodwill	Rs. 5m
Property	Rs. 33m
Equipment	Rs. 17m
Current assets	Rs. 10m

The recoverable amount of the CGU is Rs. 58m. What is the carrying amount of the property after recognising the impairment loss (to the nearest Rs'000)?

  - A Rs. 28,800,000
  - B Rs. 29,446,000
  - C Rs. 31,680,000
  - D Rs. 31,900,000

- 8** Which of the following statements about value in use are true?
- 1 Value in use is determined by estimating future cash inflows from the use of the asset for the remainder of its useful life.
  - 2 Value in use is determined by discounting future cash flows using a pre-tax rate.
- A 1 only  
B 2 only  
C Both 1 and 2  
D Neither 1 nor 2



## ANSWERS TO PROGRESS TEST

- 1 Recoverable amount is the higher of value in use and fair value less costs to sell.
- 2 Firstly as a reversal of the revaluation surplus; any excess loss is recognised in profit or loss.
- 3 Firstly to goodwill and then to other assets within the scope of LKAS 36 on a pro-rata basis.
- 4 Only where there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised.
- 5 An impairment loss in relation to goodwill cannot be reversed; an impairment loss in relation to other assets can only be reversed so that the asset's carrying amount after the reversal is the same as its carrying amount would have been had the impairment not occurred.
- 6 The answer is **A**.

	Rs'000
Cost	10,000
Depreciation (10m/50 × 6 years)	<u>(1,200)</u>
Carrying amount 31 Dec 20X7	8,800
Revaluation surplus	<u>1,100</u>
Carrying amount post revaluation	9,900
Depreciation 20X8 (9.9/44)	<u>(225)</u>
Carrying amount 31 Dec 20X8	9,675
Impairment loss	<u>(275)</u>
Recoverable amount	9,400

The impairment loss is recognised as a downwards revaluation as a reduction of the previously recognised revaluation surplus.

- 7 The answer is **C**. The impairment loss is Rs. 7m (Rs. 5m + 33m + 17m + 10m – 58m).

Rs. 5m of the loss is allocated to goodwill.

The remainder is allocated on a pro-rata basis to property and equipment. Therefore, Rs. 1.32m (Rs. 2m × 33m/50m) is allocated to property.

The carrying amount of property after the impairment is therefore Rs. 31,680,000 (Rs. 33m – 1.32m).

- 8 The answer is **B**. Cash flows to be estimated are inflows from use of the asset, outflows incurred to generate the cash inflows and net cash flow on disposal of the asset. These normally cover a maximum period of five years.



# Leases

## INTRODUCTION

When a company requires an item of property, plant and equipment, it has a choice to either buy the asset outright or lease it.

In some cases, a lease is structured such that the company effectively rents the asset; in other cases, it is structured such that the company effectively acquires the asset through a financing arrangement.

LKAS 17 deals with the accounting requirements in both of these situations.

Knowledge Component			
<b>2</b>	<b>Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)</b>		
<b>2.2</b>	<b>Level B</b>	<b>2.2.1</b>	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		<b>2.2.2.</b>	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		<b>2.2.3</b>	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		<b>2.2.4</b>	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		<b>2.2.5</b>	Outline the disclosures to be made in the financial statements.

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1 Introduction	2.2
2 Lessee accounting – operating leases	2.2
3 Lessee accounting – finance leases	2.2
4 Lessor accounting – operating leases	2.2
5 Lessor accounting – finance leases	2.2
6 Related Interpretations	2.2

**LKAS 17 Learning objectives**

- Explain the conditions to be satisfied to recognise a lease as a finance lease.
- Compute the amount at which a finance lease should be recognised in the books of lessees/lessors.
- Explain the initial measurement, subsequent measurement and disclosures of finance leases in the financial statements of lessees.
- Record finance and operating leases in the financial statements of lessees and lessors.
- Outline the disclosures to be made in respect of leases.

**1 Introduction**

A **finance lease** is a means of acquiring the long-term use of an asset, whereas an **operating lease** is a short-term rental agreement. Substance over form is important in distinguishing between them.

In a leasing transaction, there is a **contract** between the lessor and the lessee for the hire of an asset. The lessor is the supplier of the asset and the lessee is the user of the asset.

The lessor retains legal ownership but conveys to the lessee the right to use the asset for an agreed period of time in return for specified rentals.

LKAS 17 defines a lease and recognises two types:



A **lease** is an agreement whereby the lessor conveys to the lessee in return for rent the right to use an asset for an agreed period of time.

A **finance lease** is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.

An **operating lease** is a lease other than a finance lease.

The distinction between the two types of lease is important, since the accounting treatment applied to each is very different.

## 1.1 Classification of a lease

As the definition above states, a finance lease is a lease that transfers substantially all of the risks and rewards incident to ownership of an asset to the lessee.

- (a) Risks of ownership include the possibility of losses from idle capacity, technological obsolescence and falls in returns due to varying economic conditions.
- (b) Rewards of ownership include the profitable use of the asset during its economic life.

An assessment of whether risks and rewards have transferred may not be easy, and for this reason, LKAS 17 provides examples of situations that normally result in a lease being classified as a finance lease. These are:

- (a) The lease transfers ownership of the asset to the lessee by the end of the lease term
- (b) The lessee has the option to purchase the asset at a price that makes the option reasonably certain to be exercised
- (c) The lease term is for the major part of the economic life of the asset
- (d) At the inception of the lease, the present value of the minimum lease payments (discounted at the interest rate implicit in the lease) amounts to at least substantially all of the fair value of the leased asset
- (e) The leased asset is of such a specialised nature that only the lessee could use it without major modifications

The standard also provides indicators of situations that could also lead to a lease being classified as a finance lease:

- (a) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee
- (b) Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee
- (c) The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent

The following definitions from LKAS 17 apply to some of the situations listed above.



**The lease term** is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

**Minimum lease payments** are the payments over the lease term that the lessee is or can be required to make.

**The interest rate implicit in the lease** is the discount rate that, at the inception of the lease, causes the aggregate present value of:

- (a) The minimum lease payments, and
- (b) The unguaranteed residual value

To be equal to the sum of:

- (a) The fair value of the leased asset, and
- (b) Any initial direct costs

### 1.1.1 Land and buildings

Under LKAS 17, the land and buildings leased together are considered separately for the purposes of lease classification.

A lease of land is normally treated as an operating lease, unless title is expected to pass at the end of the lease term.

A lease of buildings will be treated as a finance lease if it satisfies the requirements in Section 1.1 above.

The minimum lease payments are allocated between the land and buildings elements in proportion to the relative fair values of the leasehold interests in the land and the buildings. If the value of the land is immaterial, classification will be according to the buildings.

If payments cannot be reliably allocated, the entire lease is classified as a finance lease, unless both elements are operating leases, in which case the entire lease is classified as an operating lease.



### 1.1.2 Example: land and buildings

A business has taken out a new lease on a factory building and surrounding land. The fair value of the building is Rs. 5m and the fair value of the land is Rs. 3m. The

lease is for 20 years, with annual payments in arrears of Rs. 500,000. Having assessed the situation, the business intends to classify the lease on the building as a finance lease and the lease on the land as an operating lease.

The lease payments will be split in line with the fair values of the land and the building. Rs. 187,500 ( $500,000 \times 3/8$ ) will be treated as payment on an operating lease for the land and Rs. 312,500 will be treated as payment on a finance lease for the building.

## 2 Lessee accounting – operating leases



**In the lessee's financial statements, an operating lease expense is recognised in profit or loss on a straight line basis in each year of the lease term.**

### 2.1 Accounting treatment

LKAS 17 requires that lease payments under an operating lease are recognised as an expense on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern of the user's benefit.



#### 2.1.1 Example: lessee accounting – operating leases

Alahakoon Foods (Pvt) Ltd entered into an agreement to lease an item of machinery for four years from 1 August 20X3. The machine has an expected useful life of 10 years. The terms of the lease agreement require an initial non-refundable deposit of Rs. 32,000 and then quarterly rentals of Rs. 28,000 paid in arrears.

#### Required

**Record** the expense recognised in Alahakoon's financial statements in the year ended 31 December 20X3.

#### Solution

- The total lease payments over the term of the lease amount to Rs. 480,000 ( $(4 \text{ years} \times 4 \text{ quarters} \times \text{Rs. } 28,000) + \text{Rs. } 32,000$ ).
- Spread over the lease term, this gives an annual charge to profit or loss of Rs. 120,000 ( $480,000/4 \text{ years}$ ).
- The expense in the year ended 31 December 20X3 is therefore Rs. 50,000 ( $\text{Rs. } 120,000 \times 5/12 \text{ months}$ ).
- This is recorded by (Rs.):

DEBIT	Operating lease expense	50,000	
DEBIT	Prepayment	10,000	
CREDIT	Cash (deposit and one instalment)		60,000

## 2.2 Disclosure

Lessees should disclose the following in respect of operating leases.

- (a) A general description of significant leasing arrangements
- (b) The total lease payments recognised as an expense in the period
- (c) The total of future minimum lease payments under non-cancellable operating leases for each of the following periods:
  - (1) Not later than one year
  - (2) Later than one year and not later than five years
  - (3) Later than five years



### QUESTION

### Lessee accounting – operating leases

Jaffna Tea (Pvt) Ltd entered into an operating lease on 1 March 20X5 to acquire the use of office equipment. The lease term was three years, and the agreement required payments in advance of Rs. 150,000 per annum together with a non-refundable deposit of Rs. 60,000 payable at the start of the lease.

### Required

**Explain** what amounts are recognised in the financial statements of Jaffna Tea in the year ended 31 October 20X5 in respect of the lease.

### ANSWER

The total lease expense is Rs. 510,000  $((3 \text{ years} \times \text{Rs. } 150,000) + \text{Rs. } 60,000)$ .

The annual lease expense is therefore Rs. 170,000  $(\text{Rs. } 510,000 / 3 \text{ years})$ .

Therefore, in the financial statements in the year ended 31 October 20X5, the following are recognised:

- An expense of Rs. 85,000  $(\text{Rs. } 170,000 \times 6/12\text{m})$
- A prepayment of Rs. 125,000  $(\text{Rs. } 210,000 \text{ paid to date} - \text{expense of Rs. } 85,000)$



### 3 Lessee accounting – finance leases



**Lessees** should recognise an asset and corresponding lease obligation in respect of assets acquired under a finance lease.

#### 3.1 Accounting treatment

##### 3.1.1 Initial recognition and measurement

LKAS 17 requires that when an asset is acquired under a finance lease, the lessor should recognise an asset and corresponding lease liability. In the lessee's books therefore:

DEBIT	Asset
CREDIT	Lease liability

The asset and liability are measured at the lower of the fair value and the present value of the minimum lease payments.

##### 3.1.2 Subsequent accounting for the asset

The asset should be depreciated over the shorter of the following:

- The lease term
- The asset's useful life

If there is reasonable certainty of eventual ownership of the asset, then it should be depreciated over its useful life.

##### 3.1.3 Subsequent accounting for the liability

The liability initially recognised is equal to the fair value of the asset (or present value of minimum lease payments if lower). This is less than the total lease payments, the difference being interest which accrues on the outstanding liability with the passage of time.

Over the lease term, the lease liability will:

- Increase as interest accrues to it
- Decrease as payments are made

Payments are deemed to be partly a payment of interest and partly a payment of the outstanding obligation.

The amount of interest arising in a given period is calculated so as to give a constant periodic rate of interest on the remaining balance of the liability. This is achieved using the actuarial method, demonstrated in the following example.



### 3.1.4 Example: actuarial method

On 1 January 20X0, Rupasinghe Beverages PLC acquires a bottling and labelling machine under a finance lease. The cash price of the machine was Rs. 77,100. The agreement required the immediate payment of a Rs. 20,000 deposit with the balance being settled in four equal annual instalments of Rs. 20,000, commencing on 31 December 20X0. The interest rate implicit in the lease is 15% per annum. Rupasinghe's year end is 31 December.

#### Required

**Calculate** the interest charge in each year of the lease term and the outstanding liability at each year end.

#### Solution

Total lease payments over the term (including the deposit) amount to Rs. 100,000. Therefore, interest charged in total over the lease term is Rs. 22,900.

Interest is calculated in each period as 15% of the brought forward obligation as follows.

	<i>B/f obligation at 1 January Rs</i>	<i>Interest charge (15%) Rs</i>	<i>Payment Rs</i>	<i>C/f obligation at 31 December Rs</i>
Cash price	77,100			
Deposit	<u>(20,000)</u>			
20X0	57,100	8,565	(20,000)	45,665
20X1	45,665	6,850	(20,000)	32,515
20X2	32,515	4,877	(20,000)	17,392
20X3	17,392	<u>2,608</u>	(20,000)	-
		<u>22,900</u>		

In this example, lease payments are in arrears; if lease payments are made in advance, the form of the lease obligation table is slightly different.



### 3.1.5 Example: payments in arrears

Abekoon Transport PLC acquired an asset with a fair value of Rs. 102,500 and a useful life of five years by way of a finance lease on 1 July 20X0. The lease term was five years and the contract required five payments in advance of Rs. 25,000. The interest rate implicit in the lease is 11% and Abekoon's year end is 30 June.

## Required

Draw up the lease obligation table for Abekoon for the whole five-year period, identifying amounts to be recognised in profit or loss in the year ended 30 June 20X1.

## Solution

	<i>B/f at 1 July</i>	<i>Repayment</i>	<i>C/f</i>	<i>Interest at 11%</i>	<i>C/f at 30 June</i>
	Rs	Rs	Rs	Rs	Rs
20X1	102,500	(25,000)	77,500	8,525	86,025
20X2	86,025	(25,000)	61,025	6,713	67,738
20X3	67,738	(25,000)	42,738	4,701	47,439
20X4	47,439	(25,000)	22,439	2,468	24,907
20X5	24,907	(25,000)*			

\* There is a rounding difference of Rs. 93.

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 JUNE 20X1	Rs
Depreciation (Rs. 102,500/5 years)	20,500
Finance cost	8,525

Note that in this example, interest is calculated **after** the repayment, ie it is based on the amount owed throughout each year. Therefore, the table includes items in a different order to that seen previously.

### 3.1.6 Different payment schedules

In both of the examples seen so far, payments are made annually. Where payments are required more frequently, such as monthly or quarterly, the finance lease obligation table is drawn up in the same way as we have seen, but with one row for each payment period. Therefore, in the case of quarterly payments, the table would require four rows for each accounting year.

## 3.2 Disclosure

LKAS 17 (revised) requires the following disclosures by lessees in respect of finance leases.

- A general description of the lessee's material leasing arrangements
- The **net carrying amount** at the end of the reporting period for each class of asset
- A **reconciliation** between the total of minimum lease payments at the end of the reporting period, and their present value. In addition, an entity should

disclose the total of minimum lease payments at the end of the reporting period, and their present value, for each of the following periods:

- (i) Not later than one year
- (ii) Later than one year and not later than five years
- (iii) Later than five years

In order to comply with the requirements of LKAS 1, the year end finance lease obligation must also be split between current and non-current amounts due.

It is usually easiest to work out the amount of the obligation that will be paid within one year first; the balance of the obligation will therefore be the non-current liability.



### 3.2.1 Example: current and non-current liability 1

The following is an extract from Rupasinghe Beverages PLC's lease obligation table in Example 3.1.4.

	<i>B/f obligation at 1 January</i>	<i>Interest charge (15%)</i>	<i>Payment</i>	<i>C/f obligation at 31 December</i>
	Rs	Rs	Rs	Rs
Cash price	77,100			
Deposit	<u>(20,000)</u>			
20X0	57,100	8,565	(20,000)	45,665
20X1	45,665	6,850	(20,000)	32,515

- At 31 December 20X0, the outstanding obligation is Rs. 45,665.
- Rs. 20,000 will be paid in the next year, but this includes payment of Rs. 6,850 interest which only accrues with the passage of time, ie at 31 December 20X0 it is not yet owed.
- Therefore, at 31 December 20X0 the current liability is Rs. 13,150 (20,000 – 6,850).
- The non-current liability is therefore Rs. 32,515 (45,665 – 13,150).
- **Where payments are made in arrears, the current liability at a given year end is the following year's total payments less the following year's total interest.**



### 3.2.2 Example: current and non-current liability 2

The following is an extract from Abekoon Transport PLC's lease obligation table in Example 3.1.5.

	<i>B/f at 1 July</i>	<i>Repayment</i>	<i>C/f</i>	<i>Interest at 11%</i>	<i>C/f at 30 June</i>
	Rs	Rs	Rs	Rs	Rs
20X1	102,500	(25,000)	77,500	8,525	86,025
20X2	86,025	(25,000)	61,025	6,713	67,738

- At 30 June 20X1, the outstanding obligation is Rs. 86,025.
- Rs. 25,000 will be paid in the next year. This includes 20X1 interest of Rs. 8,525, which has already accrued and therefore is currently owed.
- Therefore, at 31 December 20X0 the current liability is Rs. 25,000.
- The non-current liability is therefore Rs. 61,025 (86,025 – 25,000).
- **Where payments are made in advance, the current liability at a given year end is equal to the following year's total payments.**



### QUESTION

#### Quarterly payments

Meepitiya Gardening Services (Pvt) Ltd acquires a machine on 1 August 20X1 under a finance lease with a five-year term. The fair value of the machine is Rs. 500,000 and it has a useful life of six years. The lease term requires payments of Rs. 130,000 in arrears, and the interest rate implicit in the lease is 19.5%.

#### Required

**Record** the amounts recognised in the financial statements in respect of the lease in the year ended 31 July 20X2.

### ANSWER

<b>Statement of financial position</b>	Rs
Non-current asset ( $500,000 \times 4/5$ years)	400,000
Non-current liability ( $417,500 - 90,337$ ) (W1)	327,163
Current liability ( $130,000 - 39,663$ ) (W1)	90,337
<b>Statement of profit or loss</b>	Rs
Depreciation ( $500,000 \times 1/5$ years)	100,000
Finance costs (W1)	47,500

*Workings*

	<i>B/f obligation at 1 August</i>	<i>Interest charge (10%)</i>	<i>Payment</i>	<i>C/f obligation at 31 July</i>
	Rs	Rs	Rs	Rs
20X1/2	500,000	47,500	(130,000)	417,500
20X2/3	417,500	39,663	(130,000)	327,163

## 4 Lessor accounting – operating leases



**In the lessor's financial statements, operating lease** income is recognised in profit or loss on a straight line basis in each year of the lease term.

### 4.1 Accounting treatment

LKAS 17 requires that operating leases are recognised in the financial statements of a lessor as follows.

- (1) The underlying asset is presented according to the nature of the asset, with depreciation recognised in profit or loss.
- (2) Any initial direct costs incurred in negotiating and arranging an operating lease are added to the carrying amount of the asset and recognised as an expense over the lease term.
- (3) Lease income is recognised in profit or loss on a straight line basis over the lease term, unless another systematic basis is more representative of the pattern in which benefits derived from the asset diminish.



#### 4.1.1 Example: lessor accounting – operating leases

Hippala Leasing PLC leases office equipment to a number of companies in Colombo. On 1 January 20X5 it entered into a lease agreement with another company for the supply of three photocopiers for three years, at a total cost of Rs. 150,000 per annum payable in arrears. The costs of negotiating the lease amounted to Rs. 21,000. The photocopiers were purchased by Hippala on 1 January 20X5 at a cost of Rs. 200,000 each and they have an estimated useful life of five years.

#### Required

**Record** the amounts Hippala should recognise in profit and loss in the year ended 31 December 20X5 in respect of the leased assets.

### Solution

The following amounts are recognised:	Rs
Depreciation ((Rs. 200,000 × 3)/5 years)	(120,000)
Amortisation of negotiation costs (Rs. 21,000/3 years)	(7,000)
Operating lease income	150,000

## 4.2 Disclosure

Lessors should disclose the following in respect of operating leases.

- (a) A general description of the lessor's leasing arrangements
- (b) The future minimum lease payments under non-cancellable operating leases in aggregate and for each of the following periods:
  - (i) Not later than one year
  - (ii) Later than one year and not later than five years
  - (iii) Later than five years

## 5 Lessor accounting – finance leases



**A lessor derecognises an asset** that is leased out under a finance lease and instead recognises the amount due from the lessee.

### 5.1 Definitions

LKAS 17 provides further definitions that are relevant to lessor accounting.



**The net investment in the lease** is the gross investment in the lease discounted at the interest rate implicit in the lease.

**The gross investment in the lease** is the aggregate of:

- The minimum lease payments receivable by the lessor under a finance lease
- Any unguaranteed residual value accruing to the lessor

**An unguaranteed residual value** is that portion of the residual value of a leased asset that the lessor is not assured.

**Unearned finance income** is the difference between the net investment in the lease and the gross investment in the lease.

## 5.2 Accounting treatment

Lessors do not recognise an asset that is leased out under a finance lease, but should instead recognise a receivable at an amount equal to the net investment in the lease plus any direct costs incurred in negotiating the lease.

Over the lease term, the receivable will:

- Increase as interest accrues to it
- Decrease as payments are received

Interest income is recognised to reflect a constant periodic rate of return on the lessor's net investment in the finance lease.

In effect, therefore, this is the opposite accounting to the lessee who recognises a lease obligation and accrues interest payable.



### 5.2.1 Example: lessor accounting – finance leases

Colombo Contracts PLC leased an asset to another company for five years with effect from 1 October 20X4. The fair value of the asset on this date was Rs. 100,000 and legal fees payable by Colombo Contracts amounted to Rs. 2,500. Rentals of Rs. 25,000 are payable to Colombo Contracts in advance and the interest rate implicit in the lease is 11%.

#### Required

**Record** the amounts that should be recognised in Colombo Contract's financial statements in the year ended 30 September 20X5 in respect of the lease.

#### Solution

The net investment is initially recognised at Rs. 102,500:

	<i>B/f at</i> <i>1 October</i>	<i>Repayment</i>	<i>C/f</i>	<i>Interest at</i> <i>11%</i>	<i>C/f at</i> <i>30 September</i>
	Rs	Rs	Rs	Rs	Rs
20X4/5	102,500	(25,000)	77,500	8,525	86,025
20X5/6	86,025	(25,000)	61,025	6,713	67,738

The total receivable at 30 September 20X5 is Rs. 86,025 and, in accordance with LKAS 1, this is split between current and non-current amounts. Therefore, in the financial statements:

- A current asset (net investment in the finance lease) of Rs. 25,000 is recognised.
- A non-current asset (net investment in the lease) of Rs. 61,025 (86,025 – 25,000) is recognised.
- Interest income of Rs. 8,525 is recognised.



Note that, as before, where payments are in advance, the current asset is the total payment receivable in the following year; where payments are in arrears, the current asset will be the payment receivable in the following year less interest that has not yet accrued in respect of the following year.

### 5.3 Disclosure

In respect of finance leases, lessors should disclose:

- (a) A general description of the lessor's material leasing arrangements
- (b) A reconciliation between the gross investment in the lease at the end of the reporting period and the present value of minimum lease payments receivable at the end of the reporting period
- (c) The gross investment in the lease and present value of minimum lease payments receivable at the end of the reporting period for each of the following periods:
  - (i) Not later than one year
  - (ii) Later than one year and not later than five years
  - (iii) Later than five years
- (d) Unearned finance income
- (e) Unguaranteed residual values accruing to the benefit of the lessor

## 6 Related interpretations



**SIC-15 *Operating leases – incentives* and IFRIC 4 *Determining whether an arrangement contains a lease*** are relevant to lease accounting.

Interpretations are issued by the IASB (and adopted by CASL) to clarify how accounting standards should be applied. Two interpretations are related to LKAS 17 and lease accounting.

### 6.1 SIC-15 *Operating leases – incentives*

SIC-15 confirms that operating lease expenses/income should be recognised on a straight line basis where the lessor provides incentives for the lessee to enter into the agreement.

Incentives may include upfront cash payments or initial rent-free periods.

The total rental expense/income is spread over the lease term such that:

- The lessor recognises the cost of incentives as a reduction of rental income over the lease term
- The lessee recognises the benefit of incentives as a reduction of rental expense over the lease term



## QUESTION

## Operating lease incentives

De Silva Manufacturing (Pvt) Ltd entered into an agreement to lease a machine for four years from 1 August 20X5. The terms of the agreement required quarterly payments of Rs. 25,000 in arrears after an initial rent-free quarter.

### Required

**Calculate** the amount De Silva Manufacturing should recognise as an expense in the year ended 31 March 20X6 in respect of the lease.

## ANSWER

- The total rental expense over the lease term is Rs. 375,000 ( $\text{Rs. } 25,000 \times 15 \text{ quarters}$ ).
- The annual rental charge is therefore Rs. 93,750 ( $\text{Rs. } 375,000 / 4 \text{ years}$ ).
- The expense in the year ended 31 March 20X6 is therefore Rs. 62,500 ( $\text{Rs. } 93,750 \times 8 / 12 \text{ months}$ ).

## 6.2 IFRIC 4 *Determining whether an arrangement contains a lease*

### 6.2.1 The issue

Arrangements may exist that do not take the legal form of a lease but which convey rights to use assets in return for a payment or series of payments. Such arrangements may include:

- Outsourcing arrangements
- Telecommunication contracts that provide rights to capacity
- Take-or-pay and similar contracts, in which purchasers must make specified payments regardless of whether they take delivery of the contracted products or services

### 6.2.2 Accounting treatment

IFRIC 4 specifies that an arrangement that meets both of the following criteria is a lease, or contains a lease and so should be accounted for in accordance with LKAS 17 *Leases*.

- (a) Fulfilment of the arrangement depends on a specific asset. The asset need not be explicitly identified by the contractual provisions of the arrangement. Rather, it may be implicitly specified because it is not economically feasible or practical for the supplier to fulfil the arrangement by providing use of alternative assets.
- (b) The arrangement conveys a right to control the use of the underlying asset. This is the case if any of the following conditions are met.
  - (i) The purchaser in the arrangement has the ability or right to operate the asset or direct others to operate the asset (while obtaining more than an insignificant amount of the output of the asset).
  - (ii) The purchaser has the ability or right to control physical access to the asset (while obtaining more than an insignificant amount of the output of the asset).
  - (iii) There is only a remote possibility that parties other than the purchaser will take more than an insignificant amount of the output of the asset, and the price that the purchaser will pay is neither fixed per unit of output nor equal to the current market price at the time of delivery.



## CHAPTER ROUNDUP

- ↪ A **finance lease** is a means of acquiring the long-term use of an asset, whereas an **operating lease** is a short-term rental agreement. Substance over form is important in distinguishing between them.
- ↪ **In the lessee's financial statements, an operating lease** expense is recognised in profit or loss on a straight line basis in each year of the lease term.
- ↪ **Lessees** should recognise an asset and corresponding lease obligation in respect of assets acquired under a finance lease.
- ↪ **In the lessor's financial statements, operating lease** income is recognised in profit or loss on a straight line basis in each year of the lease term.
- ↪ **A lessor derecognises an asset** that is leased under a finance lease and instead recognises the amount due from the lessee.
- ↪ **SIC-15 Operating leases – incentives** and **IFRIC 4 Determining whether an arrangement contains a lease** are relevant to lease accounting.


**PROGRESS TEST**

- 1 Fill in the blanks in the sentences below.
  - (a) \_\_\_\_\_ leases transfer substantially all the risks and rewards of ownership.
  - (b) \_\_\_\_\_ leases are usually short-term rental agreements with the lessor being responsible for the repairs and maintenance of the asset.
- 2 A business acquires an asset under an operating lease, paying an upfront deposit. How is the deposit accounted for?
- 3 A business acquires an asset under a finance lease. What is the double entry?
- 4 A lorry has an expected useful life of six years. It is acquired under a four-year finance lease. Over which period should it be depreciated?
- 5 A company leases a photocopier to another company under an operating lease that expires in June 20X2. It also leases out a machine under an operating lease due to expire in January 20X3. How should past and future operating leases be disclosed in its 31 December 20X1 accounts?
- 6 Weerakoon Sugar PLC acquired an asset by way of a lease agreement in 20X5. The lease term is for six years, after which Weerakoon has the option to purchase the price at 10% of its market value on that date.  
 What type of lease is this?
  - A Operating lease
  - B Finance lease
- 7 A company acquires an asset with a fair value of Rs. 420,000 and a useful economic life of six years under a finance lease contract on 1 January 20X1. The present value of minimum lease payments is Rs. 390,000 and the lease term is five years.  
 What is the depreciation charge in the year ended 31 December 20X1?
  - A Rs. 70,000
  - B Rs. 84,000
  - C Rs. 65,000
  - D Rs. 78,000

- 8** On 1 January 20X5, Dias Perera PLC commenced a lease agreement with another company to rent land to it for five years. The lease requires Rs. 60,000 to be paid annually in advance. At the start of the lease, Dias Perera made an incentive payment of Rs. 20,000 to the other company.

What amount should Dias Perera recognise as income in its financial statements in the year ended 31 December 20X5?

- A Rs. 60,000
- B Rs. 40,000
- C Rs. 56,000
- D Rs. 64,000

## ANSWERS TO PROGRESS TEST

- 1 (a) Finance  
(b) Operating
- 2 The deposit is recognised as an expense spread across the lease term.
- 3 DEBIT                      Asset account  
CREDIT                    Lease liability
- 4 The four-year term, being the shorter of the lease term and the useful life.
- 5 The total operating lease rental income in profit or loss should be disclosed. Future income should be disclosed, analysed between amounts falling due in the next year and the second to fifth years.
- 6 The answer is **B**. The option to purchase the asset at the end of the lease term is reasonably certain to be exercised given the low price and therefore LKAS 17 states that this is a finance lease.
- 7 The answer is **D**. The asset is recognised at the lower of fair value and the present value of minimum lease payments.  
  
The asset is depreciated over the shorter of the useful life and the lease term.
- 8 The answer is **C**. Total income is Rs. 300,000. The operating lease incentive reduces this to Rs. 280,000.  
  
Spread over the lease term, this gives income of Rs. 56,000 to Dias Perera per annum.





# Other Standards Related to Assets

## INTRODUCTION

This chapter deals with four accounting standards, one of which you have already met at KE1 level. They are:

- LKAS 2 *Inventories*
- LKAS 11 *Construction contracts*
- LKAS 20 *Government grants*
- LKAS 41 *Agriculture*

Knowledge Component			
2	Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)		
2.1	Level A	2.1.1	Advise on the application of Sri Lanka Accounting Standards in solving complicated matters.
		2.1.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in conformity with Sri Lanka Accounting Standards.
		2.1.3	Evaluate the impact of application of different accounting treatments.
		2.1.4	Propose appropriate accounting policies to be selected in different circumstances.
		2.1.5	Evaluate the impact of use of different expert inputs to financial reporting.

Knowledge Component		
2.2 <b>Level B</b>	2.1.6	Advise on the appropriate application and selection of accounting/ reporting options given under standards.
	2.1.7	Design the appropriate disclosures to be made in the financial statements.
	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
	2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
	2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
	2.2.4	Demonstrate appropriate application and selection of accounting/ reporting options given under standards.
	2.2.5	Outline the disclosures to be made in the financial statements.

CHAPTER CONTENTS	LEARNING OUTCOME
1 LKAS 2 <i>Inventories</i>	2.2
2 LKAS 11 <i>Construction contracts</i>	2.2
3 LKAS 20 <i>Government grants</i>	2.2
4 LKAS 41 <i>Agriculture</i>	2.2

## LKAS 2 Learning objectives

- Explain inventory and the basis of measurement of inventories.
- Discuss the composition of cost of inventories.
- Demonstrate the concept of net realisable value (NRV).
- Compute cost and NRV of inventories.
- Outline the disclosures to be made in respect of inventories.

## LKAS 11 Learning objectives

- Explain construction contracts.
- Demonstrate the criteria to be satisfied to recognise the contract revenue and contract cost.
- Compute revenue from construction contract.
- Explain how to recognise expected losses.
- Compute expected losses from construction contract.
- Explain the components of contract costs.
- Explain accounting for change in estimate of contract revenue or contract cost.
- Outline the disclosures to be made in respect of construction costs.

## LKAS 20 Learning objectives

- Compare government assistance and government grants.
- Explain the recognition criteria of government grants.
- Explain the presentation of grants relating to assets and income.
- Prepare the financial statements applying requirements for grants related to assets and grants related to income.
- Outline the disclosure requirements with regard to accounting for government grants as per the standard.

## LKAS 41 Learning objectives

- Explain agriculture, agriculture produce, biological asset and biological transformation.
- Explain when a biological asset can be recognised.
- Explain measurement of biological assets.
- Compute the cost of a biological asset at initial measurement.
- Compute gains and losses on initial recognition and subsequent measurement of biological assets.
- Explain the adjustments relating to government grants recovered in respect of biological assets.
- List the disclosures to be made in respect of biological assets.

## 1 LKAS 2 *Inventories*



**Inventories are measured at the lower of cost and net realisable value.**

LKAS 2 was covered at the KE1 Level. The first section of this chapter revises the requirements of the standard.

In most businesses, the measurement of inventory is an important factor in the determination of profit. Inventory measurement is, however, a highly subjective exercise and consequently there is a wide variety of different methods used in practice.

### 1.1 Scope of LKAS 2

The following items are excluded from the scope of the standard.

- Work in progress under construction contracts (covered by LKAS 11 *Construction contracts*, see Section 2)
- Financial instruments (eg shares and bonds)
- Biological assets

Certain inventories are exempt from the standard's measurement rules, ie those held by:

- Producers of agricultural and forest products
- Commodity-broker traders

## 1.2 Definition of inventories

LKAS 2 provides a definition of inventories, as follows.



**Inventories** are assets:

- Held for sale in the ordinary course of business
- In the process of production for such sale, or
- In the form of materials or supplies to be consumed in the production process or in the rendering of services

Inventories can include goods purchased and held for resale, finished goods, work in progress and raw materials.

## 1.3 Measurement

Inventories are measured at the lower of cost and net realisable value.



**Net realisable value** is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

## 1.4 Cost of inventories

The cost of inventories includes costs of purchase, costs of conversion and any other costs in bringing the inventories to their present location and condition (see the table below).

<b>Costs of purchase</b>	<ul style="list-style-type: none"> <li>• Purchase price <b>plus</b></li> <li>• Import duties and other taxes <b>plus</b></li> <li>• Transport, handling and any other cost directly attributable to the acquisition of finished goods, services and materials <b>less</b></li> <li>• Trade discounts, rebates and other similar amounts</li> </ul>
<b>Costs of conversion</b>	<ul style="list-style-type: none"> <li>• Costs directly related to the units of production, eg direct materials and direct labour</li> <li>• Fixed and variable production overheads that are incurred in converting materials into finished goods, allocated on a systematic basis</li> </ul> <p>The standard emphasises that fixed production overheads must be allocated to items of inventory on the basis of the normal capacity of the production facilities.</p>

### 1.4.1 Excluded costs

The standard lists types of cost that are not to be included in cost of inventories. Instead, these costs should be recognised as an expense in the period they are incurred.

- (a) **Abnormal amounts** of wasted materials, labour or other production costs
- (b) **Storage costs** (except costs that are necessary in the production process before a further production stage)
- (c) **Administrative overheads** not incurred to bring inventories to their present location and conditions
- (d) **Selling costs**

### 1.4.2 Cost formulae

The specific cost of some items can be established. They are:

- (a) Items that are **not ordinarily interchangeable**
- (b) Goods or services produced and segregated for **specific projects**

Where there are a large number of interchangeable items, the cost of individual items of inventory must be assigned using a cost formula. LKAS 2 permits the use of:

- FIFO (first in, first out)
- AVCO (weighted average cost)

You should be familiar with these methods from your earlier studies. Under the weighted average cost method, a recalculation can be made after each purchase, or alternatively only at the period end.

The same cost formula must be applied to all inventories with a similar nature and use to the entity.

The following question is taken from the KE1 Study Text, and will test how well you remember and understand the requirements of LKAS 2 in relation to determining cost.



#### QUESTION

#### Cost of inventory

You are the accountant at Water Pumps Co, and you have been asked to determine the cost of the company's inventory at cost at its year end of 30 April 20X5.

Water Pumps manufactures a range of pumps. The pumps are assembled from components bought by Water Pumps (the company does not manufacture any parts).

The company does not use a standard costing system, and work in progress and finished goods are valued as follows.

- (a) Material costs are determined from the product specification, which lists the components required to make a pump.
- (b) The company produces a range of pumps. Employees record the hours spent on assembling each type of pump, this information is input into the payroll system, which prints the total hours spent each week assembling each type of pump. All employees assembling pumps are paid at the same rate and there is no overtime.
- (c) Overheads are added to the inventory value in accordance with LKAS 2 *Inventories*. The financial accounting records are used to determine the overhead cost, and this is applied as a percentage based on the direct labour cost.

For direct labour costs, you have agreed that the labour expended for a unit in work in progress is half that of a completed unit.

The draft accounts show the following materials and direct labour costs in inventory.

	<i>Raw materials</i>	<i>Work in progress</i>	<i>Finished goods</i>
Materials (Rs)	74,786	85,692	152,693
Direct labour (Rs)		13,072	46,584

The costs incurred in April, as recorded in the financial accounting records, were as follows.

	Rs
Direct labour	61,320
Selling costs	43,550
Depreciation and finance costs of production machines	4,490
Distribution costs	6,570
Factory manager's wage	2,560
Other production overheads	24,820
Purchasing and accounting costs relating to production	5,450
Other accounting costs	7,130
Other administration overheads	24,770

For your calculations, assume that all work in progress and finished goods were produced in April 20X5 and that the company was operating at a normal level of activity.

### Required

**Calculate** the cost of raw materials, work in progress and finished goods in accordance with LKAS 2 *Inventories*.

**ANSWER***Calculation of overheads for inventory*

Production overheads are as follows.

	Rs
Depreciation/finance costs	4,490
Factory manager's wage	2,560
Other production overheads	24,820
Accounting/purchase costs	<u>5,450</u>
	<u>37,320</u>

Direct labour = Rs. 61,320

$$\therefore \text{Production overhead rate} = \frac{37,320}{61,320} = 60.86\%$$

**INVENTORY VALUATION**

	<i>Raw materials</i> Rs	<i>WIP</i> Rs	<i>Finished goods</i> Rs	<i>Total</i> Rs
Materials	74,786	85,692	152,693	313,171
Direct labour	–	13,072	46,584	59,656
Production overhead (at 60.86% of labour)	<u>–</u>	<u>7,956</u>	<u>28,351</u>	<u>36,307</u>
	<u>74,786</u>	<u>106,720</u>	<u>227,628</u>	<u>409,134</u>

Variable overheads will be included in the cost of inventory.

**1.5 Net realisable value (NRV)**

Inventories are written down to their NRV where this falls below cost. NRV is likely to be less than cost where there has been:

- An increase in costs or a fall in selling price
- A physical deterioration in the condition of inventory
- Obsolescence of products
- A decision as part of the company's marketing strategy to manufacture and sell products at a loss
- Errors in production or purchasing

The following points are made by LKAS 2.

- A write down of inventories normally takes place on an item-by-item basis, but similar or related items may be grouped together.



- (b) The assessment of NRV should take place at the same time as estimates are made of selling price, using the most reliable information available. Fluctuations of price or cost should be taken into account if they relate directly to events after the reporting period, which confirm conditions existing at the end of the period.
- (c) The reasons why inventory is held must be taken into account. For example, some inventory may be held to satisfy a firm contract, and its NRV will therefore be the contract price.
- (d) NRV must be reassessed at the end of each period and compared again with cost. If the NRV has risen for inventories held over the end of more than one period, then the previous write down is reversed to the extent that the inventory is then valued at the lower of cost and the new NRV. This may be possible when selling prices have fallen in the past and then risen again.
- (e) On occasion, a write down to NRV may be of such size, incidence or nature that it must be disclosed separately.



### QUESTION

### Measurement of inventories

A company has inventory on hand at the end of the reporting period as follows.

	<i>Units</i>	<i>Raw material cost</i>	<i>Attributable production overheads</i>	<i>Attributable selling costs</i>	<i>Expected selling</i>
		Rs	Rs	Rs	Rs
Item A	300	160	15	12	185
Item B	250	50	10	10	75

At what amount will inventories be stated in the statement of financial position in accordance with LKAS 2?

### ANSWER

	<i>Units</i>	<i>Cost</i>	<i>NRV</i>	<i>Lower</i>	<i>Total</i>
		Rs	Rs	Rs	Rs
Item A	300	175	173	173	51,900
Item B	250	60	65	60	15,000
					<u>66,900</u>

## 1.6 Recognition as an expense

The carrying amount of an item of inventory is recognised as an expense in the period in which the related revenue is recognised.

The amount of any write-down of inventories to NRV and all losses of inventories are recognised as an expense in the period the write-down or loss occurs.

The amount of any reversal of any write-down of inventories, arising from an increase in NRV, is recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs.

## 1.7 Disclosure

The financial statements should disclose the following.

- (a) **Accounting policies** adopted in measuring inventories, including the cost formula used
- (b) **Total carrying amount of inventories** and the carrying amount in classifications appropriate to the entity
- (c) **Carrying amount** of inventories carried at NRV



### 1.7.1 Example disclosure

An example of disclosure for inventories is given below.

#### Note 1 **Accounting policies**

##### **Inventories**

Inventories are valued at the lower of cost and NRV. Cost is determined using the first in, first out (FIFO) method. Net realisable value is the estimated selling price in the ordinary course of business, less the costs estimated to make the sale.

#### Note X **Inventories**

	<i>20X1</i>	<i>20X0</i>
	Rs'000	Rs'000
Raw materials	31	28
Work in progress	23	25
Finished goods	<u>25</u>	<u>15</u>
	<u>79</u>	<u>68</u>

Included in the carrying value presented above was Rs. 8,000 (20X0: Rs. 10,000) of inventories held at NRV.

## 2 LKAS 11 *Construction contracts*



**A construction contract is a contract that spans a year end; revenue and costs are recognised depending on the stage of completion.**

LKAS 11 *Construction contracts* deals with the problem of how to account for a long-term contract to provide goods or services, in particular when to recognise revenue and costs.

For example, a construction company is building a large tower block under a contract with an investment property company. It will take three years to build the block, and over that time the construction company will have to pay for building materials, wages of workers on the building, architects' fees and so on. The investment property company makes periodic payments at predetermined stages of the construction. LKAS 11 determines what amounts are recognised as revenue and expenses in each of the three years of construction.

### 2.1 Definition of a construction contract



A **construction contract** is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology, function, or ultimate use.

Construction contracts may involve the building of one asset, eg a bridge, or a series of interrelated assets, eg an oil refinery. They may also include **rendering of services** (eg architects) or restoring or demolishing an asset.

Note that although the definition of a construction contract does not specifically refer to the contract spanning a reporting date, the standard states that this is usually the case.

#### 2.1.1 Types of construction contracts

Construction contracts may be fixed price contracts or cost plus contracts.



A **fixed price contract** is a construction contract in which the contractor agrees to a fixed contract price, which is sometimes subject to cost escalation clauses.

A **cost plus contract** is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

### 2.1.2 Combining and segmenting construction contracts for accounting purposes

The standard lays out the factors that determine whether the construction of a **series of assets** under one contract should be treated as several contracts.

- **Separate proposals** are submitted for each asset
- **Separate negotiations** are undertaken for each asset; the customer can accept/reject each individually
- **Identifiable costs and revenues** can be separated for each asset

There are also circumstances where a group of contracts should be treated as one single construction contract.

- The group of contracts are negotiated as a single package
- Contracts are closely interrelated, with an overall profit margin
- The contracts are performed concurrently or in a single sequence

## 2.2 Contract revenue

Before considering when contract revenue and costs are recognised, it is important to establish what amounts are included.

Contract revenue is the amount specified in the contract, plus the following amounts, provided that they are probable of payment and can be reliably measured:

- Variations in contract work (instructions from the customer that change the scope of the work and so increase or decrease revenue)
- Claims (amounts that the contractor seeks from the customer as reimbursement of unforeseen costs)
- Incentive payments (additional amounts paid by the customer if performance is met or exceeded)

Contract revenue is reduced by any penalties charged to the contractor as a result of delays and which are probable and can be reliably measured.

The result is that contract revenue is measured at the fair value of received or receivable revenue.

The total revenue may vary throughout a contract as variations, claims, incentive payments and penalties arise.

## 2.3 Contract costs

Contract costs consist of:

- Costs relating directly to the contract
- Costs attributable to general contract activity that can be allocated to the contract, such as insurance, cost of design and technical assistance not directly related to a specific contract and construction overheads
- Any other costs that can be charged to the customer under the contract, including general administration costs and development costs

Costs that relate directly to a specific contract include the following.

- Site labour costs, including site supervision
- Costs of materials used in construction
- Depreciation of plant and equipment used on the contract
- Costs of moving plant, equipment and materials to and from the contract site
- Costs of hiring plant and equipment
- Costs of design and technical assistance that are directly related to the contract
- Estimated costs of rectification and guarantee work, including expected warranty costs
- Claims from third parties

General contract activity costs should be allocated systematically and rationally, and all costs with similar characteristics should be treated consistently. The allocation should be based on the normal level of construction activity. Borrowing costs may be attributed in this way (LKAS 23: see Chapter 5).

Some costs cannot be attributed to contract activity, and so the following should be excluded from construction contract costs.

- General administration costs (unless reimbursement is specified in the contract)
- Selling costs
- R&D (unless reimbursement is specified in the contract)
- Depreciation of idle plant and equipment not used on any particular contract



## QUESTION

### Contract revenue

Alutwewa Design PLC designs and builds gardens and recreation spaces. On 1 October 20X4 it was contracted by a hotel in Colombo to redesign, build and plant the hotel gardens. The contract has a fixed price of Rs. 20m and it stipulates that:

- (a) Claims for unexpected costs up to a maximum of Rs. 500,000 are allowed
- (b) A 15% premium will be paid for completion of the gardens by 1 June 20X5

Alutwewa Design has a 31 December year end. At 31 December 20X4, the company were sure that the gardens would be complete by 1 June 20X5 despite identifying a problem with poor soil in a large area of the gardens. The costs to supply additional enriched soil for this area amount to Rs. 100,000.

### Required

**Calculate** the contract revenue at 31 December 20X4.

## ANSWER

Both the premium for early completion and the additional recoverable costs form part of revenue, since both are probable of payment and can be reliably measured.

### Contract revenue

	Rs'000
Contract price	20,000
Premium for early completion	3,000
Unexpected additional costs	500
	23,500

## 2.4 Accounting for a construction contract

The accounting treatment applied to a construction contract depends on whether the outcome of the activity can be estimated reliably.

A reliable estimate of the outcome of a construction contract can only be made when **certain conditions** have been met, and these conditions will be different for fixed price and cost plus contracts.

### Fixed price contracts

- It is probable that economic benefits of the contract will flow to the entity
- Total contract revenue can be reliably measured

- Stage of completion at the period end and costs to complete the contract can be reliably measured
- Costs attributable to the contract can be identified clearly and be reliably measured (actual costs can be compared to previous estimates)

### **Cost plus contracts**

- It is probable that economic benefits of the contract will flow to the entity
- Costs attributable to the contract (whether or not reimbursable) can be identified clearly and be reliably measured

#### **2.4.1 Stage of completion**

One of the criteria applied to assess whether a fixed price contract can be reliably estimated is whether stage of completion can be measured reliably.

LKAS 11 refers to three methods that may be used to establish stage of completion:

- (1) Costs basis: costs incurred as a proportion of total expected costs (so if total expected costs are Rs. 1m and Rs. 600,000 have been incurred, the contract is 60% complete).
- (2) Sales basis: work certified as a proportion of contract revenue (so if contract revenue is Rs. 1m and work certified is Rs. 500,000, the contract is 50% complete).
- (3) Physical completion of the contract (so if a contract is to build a 10 mile stretch of motorway and 4 miles are built, the contract is 40% complete).

## **2.5 Outcome can be reliably estimated**

Where the outcome of a construction contract can be reliably estimated, the recognition of revenue and costs depends on whether the contract is expected to be profitable or loss making.

### **2.5.1 Profitable contract**

For a profitable contract, revenue and costs are recognised by reference to the stage of completion of the contract at the reporting date. As a result:

- (a) Where the stage of completion is determined on the costs basis, cost of sales is equal to costs incurred and revenue is calculated as percentage complete  $\times$  total contract revenue.

- (b) Where the stage of completion is determined on the sales basis, revenue is equal to work certified and cost of sales is calculated as percentage complete  $\times$  total contract costs.



## QUESTION

## Stage of completion

Nikatenna Construction Co has a fixed price contract to build a tower block. The initial amount of revenue agreed is Rs. 220m. At the beginning of the contract on 1 January 20X6, the initial estimate of the contract costs is Rs. 200m. At the end of 20X6, the estimate of the total costs has risen to Rs. 202m.

During 20X7, the customer agrees to a variation that increases expected revenue from the contract by Rs. 5m and causes additional costs of Rs. 3m. At the end of 20X7, there are materials stored on site for use during the following period that cost Rs. 2.5m.

Nikatenna Construction Co has decided to determine the stage of completion of the contract by calculating the proportion that contract costs incurred for work to date bear to the latest estimated total contract costs. The contract costs incurred at the end of each year were 20X6: Rs. 52.52m, 20X7: Rs. 154.2m (including materials in store) and 20X8: Rs. 205m.

### Required

**Calculate** the stage of completion for each year of the contract and show how revenues, costs and profits will be recognised in each year.

## ANSWER

The financial data for each year end during the construction period is summarised as follows.

	20X6	20X7	20X8
	Rs'000	Rs'000	Rs'000
Initial amount of revenue agreed in the contract	220,000	220,000	220,000
Variation	–	5,000	5,000
Total contract revenue	<u>220,000</u>	<u>225,000</u>	<u>225,000</u>
Contract costs incurred to date	52,520	154,200	205,000
Contract costs to complete	<u>149,480</u>	<u>50,800</u>	–
Total estimated contract costs	<u>202,000</u>	<u>205,000</u>	<u>205,000</u>
Estimated profit	18,000	20,000	20,000
Stage of completion	26%	74%	100%



The stage of completion has been calculated using the formula:

$$\frac{\text{Contract costs incurred to date}}{\text{Total estimated contract costs}}$$

The stage of completion in 20X7 is calculated by deducting the Rs. 2.5m of materials held for the following period from the costs incurred up to that year end, ie Rs. 154.2m – Rs. 2.5m = Rs. 151.7m. Rs. 151.7m/Rs. 205m = 74%.

Revenue, expenses and profit will be recognised in profit or loss as follows.

	<i>To date</i> Rs'000	<i>Recognised in prior years</i> Rs'000	<i>Recognised in current year</i> Rs'000
20X6 Revenue (Rs. 220m × 26%)	57,200		
Costs (Rs. 202m × 26%)	<u>52,520</u>		
	<u>4,680</u>		
20X7 Revenue (Rs. 225m × 74%)	166,500	57,200	109,300
Costs (Rs. 205m × 74%)	<u>151,700</u>	<u>52,520</u>	<u>99,180</u>
	<u>14,800</u>	<u>4,680</u>	<u>10,120</u>
20X8 Revenue (Rs. 225m × 100%)	225,000	166,500	58,500
Costs (Rs. 205m × 100%)	<u>205,000</u>	<u>151,700</u>	<u>53,300</u>
	<u>20,000</u>	<u>14,800</u>	<u>5,200</u>

Therefore, when the stage of completion is determined using the contract costs incurred to date, only contract costs reflecting the work to date should be included in costs incurred to date.

Note the following:

- Exclude costs relating to future activity, eg cost of materials delivered but not yet used
- Exclude payments made to subcontractors in advance of work performed

### 2.5.2 Loss-making contract

In the case of a loss-making contract, the anticipated loss must be recognised in full immediately. Therefore:

- Where the stage of completion is determined on the costs basis, cost of sales is equal to costs incurred, the loss is recognised in full and revenue is a balancing figure (therefore it does not necessarily equal percentage complete × total contract revenue).

- (b) Where the stage of completion is determined on the sales basis, revenue is equal to work certified, the loss is recognised in full and cost of sales is a balancing figure (therefore it does not necessarily equal percentage complete  $\times$  total contract costs).

## 2.6 Outcome cannot be estimated reliably

When the contract's outcome cannot be reliably estimated, the following treatment should be followed.

- Only recognise revenue to the extent of contract costs incurred that are expected to be recoverable
- Recognise contract costs as an expense in the period they are incurred

This no profit/no loss approach reflects the situation near the beginning of a contract, ie the outcome cannot be reliably estimated, but it is likely that costs will be recovered.

Contract costs that cannot be recovered should be recognised as an expense straightaway. LKAS 11 lists the following situations where this might occur.

- The contract is not fully enforceable, ie its validity is seriously questioned
- The completion of the contract is subject to the outcome of pending litigation or legislation
- The contract relates to properties that will probably be expropriated or condemned
- The customer is unable to meet its obligations under the contract
- The contractor cannot complete the contract or in any other way meet its obligations under the contract

Where these uncertainties cease to exist, contract revenue and costs should be recognised as normal, ie by reference to the stage of completion.

## 2.7 Construction contracts in the statement of financial position

Where payments to suppliers for raw materials and progress billings to customers are not in line with amounts recognised in the statement of profit or loss, a gross amount due to or from customers is reported in the statement of financial position. This is calculated as:

	Rs
Costs incurred to date	X
Recognised profits/(losses) to date	<u>(X)</u>
	X
Progress billings to date	<u>(X)</u>
Amount due from/(to) customers	<u>X (X)</u>

In addition, a receivable amount for unpaid progress billings may be recognised.



### QUESTION

### Construction contracts in the financial statements

The main business of Santolina Dias (Pvt) Ltd is construction contracts. At the end of September 20X3, there is an uncompleted contract on the books, details of which are as follows.

#### CONTRACT B

Date commenced	1.4.X1
Expected completion date	23.12.X3

	Rs
Final contract price	290,000
Costs to 30.9.X3	210,450
Value of work certified to 30.9.X3	230,000
Progress billings to 30.9.X3	210,000
Cash received to 30.9.X3	194,000
Estimated costs to completion at 30.9.X3	20,600

Santolina calculates % completion based on work certified/contract price.

#### Required

**Prepare** calculations showing the amount to be included in the statement of profit or loss and statement of financial position at 30 September 20X3 in respect of the above contract.

**ANSWER**

The estimated final profit is:

	Rs
Final contract price	290,000
Less costs to date	(210,450)
estimated future costs	<u>(20,600)</u>
Estimated final profit	<u>58,950</u>

The recognised profit is found as follows.

$$\text{Estimated final profit} \times \frac{\text{Work certified}}{\text{Total contract price}}$$

$$\text{Rs. } 58,950 \times \frac{230,000}{290,000} = \text{Rs. } 58,950 \times 79.31\%$$

Profit recognised = Rs. 46,753

**Statement of profit or loss**

	Rs
Revenue (work certified)	230,000
Cost of sales ((210,450 + 20,600) × 79.31%)	<u>(183,247)</u>
Gross profit	<u>46,753</u>

**Statement of financial position**

*Gross amount due from customers for contract work*

	Rs
Costs to date	210,450
Attributable profit	<u>46,753</u>
	257,203
Progress billings	<u>(210,000)</u>
Amount due from customers	<u>47,203</u>
Trade receivables (210 – 194)	16,000

**QUESTION****Construction contracts**

Hippala Properties (Pvt) Ltd has two contracts in progress, the details of which are as follows.

	<i>Happy</i> (profitable)	<i>Grumpy</i> (loss-making)
	Rs'000	Rs'000
Total contract price	300	300
Costs incurred to date	90	150
Estimated costs to completion	135	225
Progress payments invoiced and received	116	116

**Required**

**Prepare** extracts from the statement of profit or loss and other comprehensive income and the statement of financial position for each contract, assuming they are both:

- (a) 40% complete
- (b) 36% complete

**ANSWER***Happy contract*

- (a) 40% complete

	Rs'000
<i>Statement of profit or loss</i>	
Revenue ( $300 \times 40\%$ )	120
Cost of sales ( $((90 + 135) \times 40\%)$ )	<u>(90)</u>
Profit to date (W)	<u>30</u>

*Workings*

<i>Profit to date</i>	Rs'000
Total contract price	300
Costs to date	(90)
Cost to completion	<u>(135)</u>
Total expected profit	<u>75</u>
Profit to date ( $75 \times 40\%$ )	30

*Statement of financial position*

	Rs'000
Costs to date	90
Profit recognised to date	30
Progress billings	<u>(116)</u>
Amount due from customers	<u>4</u>

## (b) 36% complete

	Rs'000
<i>Statement of profit or loss</i>	
Revenue ( $300 \times 36\%$ )	108
Cost of sales ( $((90 + 135) \times 36\%)$ )	<u>(81)</u>
Profit to date ( $75 \times 36\%$ )	<u>27</u>
<i>Statement of financial position</i>	
Costs to date	90
Profit recognised to date	27
Progress billings	<u>(116)</u>
Amount due from customers	<u>1</u>

*Grumpy contract*

## (a) 40% complete

	Rs'000
<i>Statement of profit or loss</i>	
Revenue ( $300 \times 40\%$ )	120
Cost of sales*	<u>(195)</u>
Foreseeable loss (W)	<u>(75)</u>

*Workings*

	Rs'000
Total contract revenue	300
Costs to date	(150)
Costs to complete	<u>(225)</u>
Foreseeable loss	<u>(75)</u>
<i>Statement of financial position</i>	
Costs to date	150
Foreseeable loss	(75)
Progress billings	<u>(116)</u>
Amounts due to customers	<u>(41)</u>
* Costs to date $(150 + 225) \times 40\%$	150
Foreseeable loss $(75) \times 60\%$ **	<u>45</u>
	<u>195</u>

\*\* The other 40% is taken into account in costs to date. We make this adjustment to bring in the **whole** of the foreseeable loss.

(b) 36% complete

	Rs'000
<i>Statement of profit or loss</i>	
Revenue ( $300 \times 36\%$ )	108
Cost of sales*	<u>(183)</u>
Foreseeable loss	<u>(75)</u>
<i>Statement of financial position</i>	
Costs to date	150
Foreseeable loss	(75)
Progress billings	<u>(116)</u>
Amount due to customers	<u>(41)</u>
* Costs to date $(150 + 225) \times 36\%$	135
Foreseeable loss $(75) \times 64\%^{**}$	<u>48</u>
	<u>183</u>

## 2.8 Changes in estimates

The effect of any change in the estimate of contract revenue or costs or the outcome of a contract should be accounted for as a change in accounting estimate under LKAS 8 *Accounting policies, changes in accounting estimates and errors*. Therefore, it is dealt with prospectively from the date of change.



### 2.8.1 Example: changes in estimates

The example below shows the effect of a change in estimate of costs on the figures that appear in the statement of profit or loss and other comprehensive income and statement of financial position.

Barnayake Developments PLC enters into a three-year contract.

Estimated revenue = Rs. 20m

Estimated total cost = Rs. 16m

However, during Year 2, management revises its estimate of total costs incurred, and thus the outcome of the contract. As a result, during Year 2, a loss is recognised on the contract for the year, even though the contract will still be profitable overall.

	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>
	Rs'000	Rs'000	Rs'000
Estimated revenue	20,000	20,000	20,000
Estimated total cost	<u>16,000</u>	<u>18,000</u>	<u>18,000</u>
Estimated total profit	<u>4,000</u>	<u>2,000</u>	<u>2,000</u>
Cost incurred to date	Rs. 8m	Rs. 13.5m	Rs. 18m
Percentage of completion	50%	75%	100%
Recognised profit/(loss) for year	Rs. 2m	(Rs. 0.5m)	Rs. 0.5m
Cumulative recognised profit	Rs. 2m	Rs. 1.5m	Rs. 2m

Progress billings of Rs. 8m, Rs. 8m and Rs. 4m are made on the last day of each year and are received in the first month of the following year. The asset at the end of each year is:

	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>
	Rs'000	Rs'000	Rs'000
Costs incurred	8,000	13,500	18,000
Recognised profits	2,000	2,000	2,500
(Recognised losses)		(500)	(500)
(Progress billings)	<u>(8,000)</u>	<u>(16,000)</u>	<u>(20,000)</u>
Amount recognised as an asset/(liability)	<u>2,000</u>	<u>(1,000)</u>	<u>0</u>

In addition, at each year end, the entity recognises a trade receivable for the amount outstanding at the end of the year of Rs. 8m, Rs. 8m and Rs. 4m.

## 2.9 Disclosure of construction contracts

LKAS 11 requires the following to be disclosed in respect of construction contracts.

- The amount of revenue recognised in the period
- The methods used to determine revenue recognised in the period
- The methods used to determine stage of completion
- The gross amount due to or from customers at the reporting date



### 3 LKAS 20 *Government grants*



**It is common for entities to receive government grants for various purposes. They may also receive other forms of assistance. The treatment of government grants is covered by LKAS 20 *Accounting for government grants and disclosure of government assistance*.**

Government grants are monetary amounts paid to a business by the authorities normally in return for meeting certain conditions such as employing a certain number of people.

They may be capital grants (grants that are made to contribute towards the acquisition of an asset) or revenue grants (grants that are made for other purposes such as the payment of wages).

Governments may also provide other forms of assistance such as marketing support, technical advice or the provision of guarantees. These types of assistance cannot reasonably have a monetary value placed on them.

#### 3.1 Scope

LKAS 20 does **not** cover the following situations.

- Accounting for government grants in financial statements reflecting the effects of changing prices
- Government assistance given in the form of 'tax breaks'
- Government acting as part-owner of the entity

#### 3.2 Definitions

These definitions are given by the standard.



**Government.** Government, government agencies and similar bodies whether local, national or international.

**Government assistance.** Action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

**Government grants.** Assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance that cannot reasonably have a value placed on them and transactions with government that cannot be distinguished from the normal trading transactions of the entity.

**Grants related to assets.** Government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire non-current assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

**Grants related to income.** Government grants other than those related to assets.

**Forgivable loans.** Loans which the lender undertakes to waive repayment of under certain prescribed conditions.

**Fair value.** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

You can see that there are many **different forms** of government assistance: both the type of assistance and the conditions attached to it will vary. Government assistance may have encouraged an entity to undertake something it otherwise would not have done.

### 3.3 Government grants

#### 3.3.1 Recognition criteria

A grant is recognised in the financial statements only when there is reasonable assurance that:

- The entity will comply with the conditions attached to the grant
- The grant will be received

Even if the grant has been received, this does not prove that the conditions attached to it have been or will be fulfilled.

It makes no difference in the treatment of the grant whether it is received in cash or given as a reduction in a liability to government, ie the manner of receipt is irrelevant.

In the case of a forgivable loan (as defined above) from the Government, it should be treated in the same way as a government grant when it is reasonably assured that the entity will meet the relevant terms for forgiveness.

The benefit of a government loan at a rate that is below the market rate of interest is treated as a government grant. The benefit is measured as the difference between the initial carrying amount of the loan at fair value in accordance with LKAS 39 and the proceeds received.

### 3.3.2 Recognition in profit or loss

LKAS 20 requires grants to be recognised as income over the relevant periods to match them to the costs that they have been received to compensate.

It is usually easy to identify the costs related to a government grant, and thereby the period(s) in which the grant should be recognised as income, ie when the costs are incurred.

- (a) Grants that are made to subsidise specific expenditure are recognised in the statement of profit or loss in the period in which that expenditure is recognised.
- (b) Grants that are made to achieve a non-financial goal are recognised in the statement of profit or loss in which the costs of meeting that goal are recognised.
- (c) Grants received as compensation for expenses or losses that have already been incurred are recognised in the period in which they are receivable.
- (d) Grants that are given to an entity to provide immediate financial support, and no future related costs are expected, are recognised when they are receivable.
- (e) Grants that are received in relation to a depreciating asset are recognised over the periods in which the asset is depreciated and in the same proportions.
- (f) In the case of grants for non-depreciable assets, certain obligations may need to be fulfilled, in which case the grant should be recognised as income over the periods in which the cost of meeting the obligation is incurred. For example, if a piece of land is granted on condition that a building is erected on it, then the grant should be recognised as income over the building's life.



#### QUESTION

#### Recognition of government grants

Rupasinghe Radios (Pvt) Ltd receives a government grant representing 50% of the cost of a depreciating asset which costs Rs. 40,000.

#### Required

**Demonstrate** how the grant will be recognised if Rupasinghe Radios depreciates the asset:

- (a) Over four years straight line
- (b) At 40% reducing balance

The residual value is nil. The useful life is four years.

**ANSWER**

The grant should be recognised in the same proportion as the depreciation.

**(a) Straight line**

	<i>Depreciation</i>	<i>Grant income</i>
	Rs	Rs
Year 1	10,000	5,000
2	10,000	5,000
3	10,000	5,000
4	10,000	5,000

**(b) Reducing balance**

	<i>Depreciation</i>	<i>Grant income</i>
	Rs	Rs
Year 1	16,000	8,000
2	9,600	4,800
3	5,760	2,880
4 (remainder)	8,640	4,320

**3.3.3 Non-monetary government grants**

A non-monetary asset may be transferred by government to an entity as a grant, for example a piece of land, or other resources. The fair value of such an asset is usually assessed and this is used to account for both the asset and the grant. Alternatively, both may be valued at a nominal amount.

**3.3.4 Presentation of grants related to assets**

There are two choices here for how government grants related to assets (including non-monetary grants at fair value) should be shown in the statement of financial position.

- (a) Set up the grant as deferred income.
- (b) Deduct the grant in arriving at the carrying amount of the asset.

These are considered to be acceptable alternatives and we can look at an example showing both.

**3.3.5 Example: accounting for grants related to assets**

A company receives a 20% grant towards the cost of a new item of machinery, which cost Rs. 100,000. The machinery has an expected life of four years and a nil residual value. The expected profits of the company, before accounting for

depreciation on the new machine or the grant, amount to Rs. 50,000 per annum in each year of the machinery's life.

### Solution

The results of the company for the four years of the machine's life would be as follows.

(a) *Reducing the cost of the asset*

	Year 1	Year 2	Year 3	Year 4	Total
	Rs	Rs	Rs	Rs	Rs
Profit before depreciation	50,000	50,000	50,000	50,000	200,000
Depreciation*	<u>20,000</u>	<u>20,000</u>	<u>20,000</u>	<u>20,000</u>	<u>80,000</u>
Profit	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>120,000</u>

\* The depreciation charge on a straight line basis, for each year, is  $\frac{1}{4}$  of Rs(100,000 – 20,000) = Rs. 20,000.

*Statement of financial position at year end (extract)*

	Rs	Rs	Rs	Rs
Non-current asset	80,000	80,000	80,000	80,000
Depreciation 25%	<u>20,000</u>	<u>40,000</u>	<u>60,000</u>	<u>80,000</u>
Carrying amount	<u>60,000</u>	<u>40,000</u>	<u>20,000</u>	<u>–</u>

(b) *Treating the grant as deferred income*

	Year 1	Year 2	Year 3	Year 4	Total
	Rs	Rs	Rs	Rs	Rs
Profit as above	50,000	50,000	50,000	50,000	200,000
Depreciation	(25,000)	(25,000)	(25,000)	(25,000)	(100,000)
Grant	<u>5,000</u>	<u>5,000</u>	<u>5,000</u>	<u>5,000</u>	<u>20,000</u>
Profit	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>120,000</u>

*Statement of financial position at year end (extract)*

Non-current asset at cost	100,000	100,000	100,000	100,000
Depreciation 25%	<u>(25,000)</u>	<u>(50,000)</u>	<u>(75,000)</u>	<u>(100,000)</u>
Carrying amount	<u>75,000</u>	<u>50,000</u>	<u>25,000</u>	<u>–</u>
Government grant deferred income	<u>15,000</u>	<u>10,000</u>	<u>5,000</u>	<u>–</u>

Whichever of these methods is used, the cash flows in relation to the purchase of the asset and the receipt of the grant are often disclosed separately because of the significance of the movements in cash flow.

Deducting the grant from the cost of the asset is simpler, but the deferred income method has the advantage that the non-current asset continues to be carried at cost in the financial statements.

### 3.3.6 Presentation of grants related to income

These grants are a credit in profit or loss, but there is a choice in the method of disclosure.

- (a) Present as a separate credit or under a general heading, eg 'other income'
- (b) Deduct from the related expense

Some would argue that offsetting income and expenses in the statement of profit or loss is not good practice. Others would say that the expenses would not have been incurred had the grant not been available, so offsetting the two is acceptable. Although both methods are acceptable, disclosure of the grant may be necessary for a proper understanding of the financial statements, particularly the effect on any item of income or expense that is required to be separately disclosed.

### 3.3.7 Repayment of government grants

If a grant must be repaid, it should be accounted for as a revision of an accounting estimate (see LKAS 8).

- (a) Repayment of a grant related to income: apply first against any unamortised deferred income set up in respect of the grant; any excess should be recognised immediately as an expense.
- (b) Repayment of a grant related to an asset: increase the carrying amount of the asset or reduce the deferred income balance by the amount repayable. The cumulative additional depreciation that would have been recognised to date in the absence of the grant should be immediately recognised as an expense.

It is possible that the circumstances surrounding repayment may require a review of the asset value and an impairment of the new carrying amount of the asset.

## 3.4 Government assistance

Some forms of government assistance cannot reasonably have a value placed on them, eg free technical or marketing advice, provision of guarantees. In addition, some transactions with government cannot be distinguished from the entity's normal trading transactions, eg government procurement policy resulting in a portion of the entity's sales.

Disclosure of such assistance may be necessary because of its significance; its nature, extent and duration should be disclosed.

### 3.5 Disclosure

Disclosure is required of the following.

- Accounting policy adopted, including method of presentation
- Nature and extent of government grants recognised and other forms of assistance received
- Unfulfilled conditions and other contingencies attached to recognised government assistance

## 4 LKAS 41 *Agriculture*



LKAS 41 provides the recognition, measurement and disclosure requirements for assets associated with agricultural activities, such as animals and crops.

LKAS 41 *Agriculture* is relevant to entities that are engaged in agricultural activity. It deals, in particular, with biological assets (except for bearer plants), agricultural produce at the point of harvest and government grants related to biological assets. It does not apply to land used for agricultural activities or intangible assets related to agricultural activities.

### 4.1 Definitions

LKAS 41 provides the following definitions relevant to agriculture.



**Agricultural activity** is the management by an entity of the biological transformation and harvest of biological assets for sale or conversion into agricultural produce or into additional biological assets.

**Agriculture produce** is the harvested product of an entity's biological assets.

A **biological asset** is a living plant or animal.

A **bearer plant** is a plant that is:

- Used in the production or supply of agricultural produce;
- Expected to bear produce for more than one period; and
- Not intended to be sold as a living plant or harvested as agricultural produce, except for incidental scrap sales.

**Biological transformation** is the processes of growth, degeneration, production and procreation that cause qualitative or quantitative changes in a biological asset.

**Harvest** is the detachment of produce from a biological asset or the cessation of a biological asset's life process. (LKAS 41)

The definition of a biological asset may include, for example, sheep, pigs, beef cattle. Dairy cows, fish, trees in a forest plants for harvest (eg wheat). It also includes bearer plants as defined above eg tea bushes, grape vines, oil palms and rubber trees. It is, however, important to understand that the accounting treatment applied to bearer plants is different from the accounting treatment applied to other biological assets:

- Bearer plants are accounted for in accordance with LKAS 16.
- Other biological assets are accounted for in accordance with LKAS 41. These include bearer biological assets that are not plants, eg milk cows.

Although bearer plants themselves are outside the scope of LKAS 41, the agricultural produce grown on them is within the scope of the standard.

Throughout the remainder of this section of the chapter, all biological assets referred to are those within the scope of LKAS 41 ie biological assets other than bearer plants.



#### 4.1.1 Example: biological assets and biological transformation

A company keeps sheep, shears them for their wool and uses it to make yarn.

- The sheep are biological assets that generate wool.
- When the company shears the sheep for their wool, the biological transformation is complete and the wool is agricultural produce.
- The sheep continue to be biological assets.
- Therefore the sheep are accounted for in accordance with LKAS 41 as biological assets and the wool and yarn are accounted for as inventory in accordance with LKAS 2.

## 4.2 Recognition

A biological asset within the scope of LKAS 41 is recognised when, and only when:

- The entity controls the asset as a result of past events
- It is probable that future economic benefits associated with the asset will flow to the entity
- The fair value or cost of the asset can be measured reliably



### 4.3 Initial measurement

A biological asset is initially measured at its fair value less costs to sell. Any gain or loss arising (being the difference between cost and initial measurement) is recognised in profit or loss.

### 4.4 Subsequent measurement

At each reporting date, a biological asset is remeasured to fair value less costs to sell, with any gain or loss resulting from a change in measurement recognised in profit or loss immediately.

### 4.5 Fair value less costs to sell

#### 4.5.1 Fair value

The definition of fair value is consistent with SLFRS 13 as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

LKAS 41 states that fair value measurement may be facilitated by grouping assets according to their age, quality or similar attributes used in the market as a basis for pricing. These attributes may include age or quality.

Where an entity has entered into a contract to sell biological assets at a future date, the contract price is not necessarily relevant in measuring fair value since it does not necessarily reflect current market conditions.

Cost may approximate fair value, particularly when:

- (a) Little biological transformation has taken place since purchase (eg where seeds are planted immediately prior to the reporting date), or
- (b) The impact of biological transformation is not expected to be material (eg the initial growth in a 30-year pine plantation production cycle)

Where biological assets are attached to land (eg trees in a plantation forest), there may be no separate market for biological assets; in this case, the fair value of the biological assets should be measured using information about the combined assets.

#### 4.5.2 Costs to sell

Costs to sell are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes.

They include commissions paid to dealers, transfer taxes and duties and fees. They do not include income taxes or finance costs.

#### **4.5.3 Inability to measure fair value reliably**

There is a rebuttable presumption that the fair value of a biological asset can be measured reliably.

This presumption can be rebutted only on initial recognition and only if quoted market prices are not available and alternative fair value measurements are determined to be unreliable.

If the presumption is rebutted, a biological asset should be measured at cost less accumulated depreciation and accumulated impairment losses.

### **4.6 Government grants and biological assets**

Government grants related to biological assets measured at fair value less costs to sell may be conditional (ie require the recipient to meet certain criteria, such as not engaging in specified agricultural activity) or be unconditional.

- (a) An unconditional government grant is recognised in profit or loss when it is receivable.
- (b) A conditional government grant is recognised only when the conditions attached to the grant are met.



#### **4.6.1 Example: conditional government grant**

An agricultural company will receive a government grant only if it farms in a particular location for five years. In this case, the grant is recognised in profit or loss at the end of the five years.

If the terms of the grant allowed part of it to be retained according to the elapsed period of time, it is recognised in profit or loss over the five years, ie as time passes.

#### **4.6.2 Grants related to biological assets measured at depreciated cost**

Where biological assets are measured at depreciated cost, government grants are recognised in accordance with LKAS 20 (see Section 3).

## 4.7 Disclosure of biological assets

In respect of biological assets, an entity must disclose:

- (a) The aggregate gain or loss in the period on initial recognition of biological assets and from the change in fair value less costs to sell of biological assets
- (b) A description of each group of biological assets
- (c) A description of the nature of activities involving each group of biological assets
- (d) Non-financial measures or estimates of physical quantities of each group of biological assets at the end of the period
- (e) Details of biological assets whose title is restricted and commitments for the acquisition of biological assets
- (f) A reconciliation of changes in the carrying amount of biological assets between the beginning and end of the current period

**QUESTION****Financial statements**

Purijjala Dairies (Pvt) Ltd acquired 1,000 milk cattle on 31 December 20X1 at a cost of Rs. 12,000 each. Relevant information about fair value and costs to sell is as follows.

	20X1	20X2	20X3
	Rs	Rs	Rs
Fair value per unit	12,000	13,500	14,800
Selling fee	5%	5.5%	5.5%

**Required**

**Record** the amounts recognised in Purijjala Dairies' financial statements in each of the years ended 31 December 20X1, 20X2 and 20X3.

**ANSWER****Statement of financial position at 31 December**

	20X1	20X2	20X3
	Rs'000	Rs'000	Rs'000
Biological assets (1000 × 12,000 × 95%)	11,400		
(1000 × 13,500 × 94.5%)		12,757.5	
(1000 × 14,800 × 94.5%)			13,986

**Statement of profit and loss for year ended 31 December**

	20X5	20X6	20X7
	Rs'000	Rs'000	Rs'000
Gain/(loss) on biological assets	(600)	1,357.5	1,228.5

**CHAPTER ROUNDUP**

- ↪ **Inventories are measured at the lower of cost and net realisable value.**
- ↪ **A construction contract is a contract that spans a year end; revenue and costs are recognised depending on the stage of completion.**
- ↪ **It is common for entities to receive government grants for various purposes. They may also receive other forms of assistance. The treatment of government grants is covered by LKAS 20 *Accounting for government grants and disclosure of government assistance*.**
- ↪ **LKAS 41 provides the recognition, measurement and disclosure requirements for assets associated with agricultural activities, such as animals and crops.**


**PROGRESS TEST**

- 1 Net realisable value is selling price less \_\_\_\_\_ less \_\_\_\_\_?
- 2 Which inventory costing method is not allowed under LKAS 2: FIFO or LIFO?
- 3 An expected loss on a construction contract is recognised in full in the year it was identified. True or false?
- 4 Which items in the statement of profit or loss and other comprehensive income and statement of financial position are affected by construction contracts?
- 5 What is the difference between a government grant and government assistance?
- 6 How is government assistance treated in the financial statements?
- 7 A vineyard keeps vines from which it harvests grapes that are made into wine. Identify the biological assets and agricultural produce.
- 8 What accounting standard is applied to each?
- 9 Which of the following is/are a current asset in the financial statements of a shipbuilding company?
  - 1 A ship under construction that will take a further estimated 600 days to complete
  - 2 An amount lent to a supplier with a repayment date in two years' time

A 1 only  
B 2 only  
C 1 and 2  
D Neither of them
- 10 A company has recorded the following costs relating to a construction contract for the design and building of a bridge.
 

Design costs	Rs. 1,000,000
Site preparation	Rs. 1,700,000
Direct labour	Rs. 5,400,000
Site supervision	Rs. 1,500,000
Materials	Rs. 3,200,000
Depreciation of plant used in the contract	Rs. 900,000

In addition, site drainage problems have been identified that will cost Rs. 500,000 to rectify; this cost can be passed back to the customer.

What are contract costs?

- A Rs. 14.2m
- B Rs. 13.7m
- C Rs. 12.8m
- D Rs. 10.3m

- 11** Dias Dairies acquired 100 dairy cattle on 31 August 20X4 at a cost of Rs. 7,000 each. This was the market price of dairy cattle at that date. At 31 December 20X4, each dairy cow had a market price of Rs. 7,800. Throughout 20X4, livestock auctioneer fees remained a constant 5% of selling price.

What amount is recognised in Dias Dairies' statement of profit or loss in respect of the cattle in the year ended 31 December 20X4?

- A Rs. 35,000 loss
- B Rs. 41,000 gain
- C Rs. 19,000 loss
- D Rs. 76,000 gain

## ANSWERS TO PROGRESS TEST

- 1 Net realisable value is selling price less costs to completion less costs necessary to make the sale.
- 2 LIFO (last in, first out)
- 3 True
- 4 Revenue and cost of sales in the statement of profit or loss and other comprehensive income. Receivables, inventory and payables in the statement of financial position.
- 5 A government grant has a monetary value whereas government assistance is governmental support or advice that cannot reasonably have a value attached to it.
- 6 If significant, its nature, extent and duration should be disclosed.
- 7 The vines are biological assets and the grapes are agricultural produce
- 8 The vines are bearer plant biological assets and therefore within the scope of LKAS 16.

Agricultural produce is within the scope of LKAS 2

- 9 The answer is **A**. The ship is inventory that will be sold in the normal operating cycle of the company and this is therefore a current asset; the loan is not due within 12 months, is not held for trading and is not part of the company's normal operating cycle, therefore it is non-current.
- 10 The answer is **A**. All of the costs qualify as contract costs.
- 11 The answer is **B**. The cost of the cattle is Rs. 700,000.

They are initially measured at Rs. 665,000 ( $\text{Rs. } 7,000 \times 100 \times 95\%$ ) and therefore there is an immediate loss of Rs. 35,000.

At the period end, they are measured at Rs. 741,000 ( $\text{Rs. } 7,800 \times 100 \times 95\%$ ); hence a gain of Rs. 76,000 is recognised.

Therefore, the net amount recognised in profit or loss is a gain of Rs. 41,000.



# Provisions and Events after the Reporting Period

## INTRODUCTION

This chapter deals with two accounting standards that were part of the KE1 syllabus: LKAS 37 *Provisions, contingent liabilities and contingent assets* and LKAS 10 *Events after the reporting period*.

In both cases, we revise KE1 material before introducing further requirements of the standard and considering the application of these requirements to given scenarios.

Knowledge Component			
<b>2</b>	<b>Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)</b>		
<b>2.1</b>	<b>Level A</b>	<b>2.1.1</b>	Advise on the application of Sri Lanka Accounting Standards in solving complicated matters.
		<b>2.1.2</b>	Recommend the appropriate accounting treatment to be used in complicated circumstances in conformity with Sri Lanka Accounting Standards.
		<b>2.1.3</b>	Evaluate the impact of application of different accounting treatments.
		<b>2.1.4</b>	Propose appropriate accounting policies to be selected in different circumstances.
		<b>2.1.5</b>	Evaluate the impact of use of different expert inputs to financial reporting.

Knowledge Component		
2.2 <b>Level B</b>	2.1.6	Advise on the appropriate application and selection of accounting/ reporting options given under standards.
	2.1.7	Design the appropriate disclosures to be made in the financial statements.
	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
	2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
	2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
	2.2.4	Demonstrate appropriate application and selection of accounting/ reporting options given under standards.
	2.2.5	Outline the disclosures to be made in the financial statements.

CHAPTER CONTENTS	LEARNING OUTCOME
1 LKAS 37 – provisions	2.2
2 LKAS 37 – contingent liabilities	2.2
3 LKAS 37 – contingent assets	2.2
4 LKAS 10 <i>Events after the reporting period</i>	2.2

## LKAS 37 Learning objectives

- Explain provisions and liabilities.
- Demonstrate the conditions to be satisfied to recognise a provision in the financial statements.
- Compute provisions to be made in the financial statements.
- Explain contingent liabilities and contingent assets.
- Discuss the factors to be considered in the measurement of provisions.
- Explain the reimbursement, changes in provisions and use of provisions.
- Discuss factors to be considered in recognising restructuring provisions.
- Outline the disclosures to be made in respect of provisions, contingent liabilities and contingent assets.

## LKAS 10 Learning objectives

- Explain 'events after the reporting period'.
- Differentiate adjusting and non-adjusting events.
- Assess whether a given event is an adjusting or non-adjusting event.
- Outline the disclosures to be made in respect of events after the reporting period.

## 1 LKAS 37 – provisions

### 1.1 Introduction



A **provision** is a liability of uncertain timing or amount.

Before LKAS 37, there was no accounting standard dealing with accounting for uncertain outcomes. As a result, companies historically used accounting for provisions as a way of smoothing or manipulating profits. This often took the form of creating a provision in a year when good profits were made and then releasing it in a subsequent year when profits were poor.

Profit smoothing such as this obviously misleads the users of financial statements, while the existence of provisions without reason in the statement of financial position results in an understatement of net assets.

LKAS 37 deals with this issue by providing recognition criteria for provisions together with measurement principles and disclosure requirements. As the standard requires a certain degree of judgement in its application, it also provides the accounting treatment to be applied in a number of scenarios.

Before considering these application scenarios, we shall revise the recognition and measurement principles introduced at KE1 level.

## 1.2 Definitions



A **provision** is a **liability** of uncertain timing or amount.

A **liability** is an obligation of an entity to transfer economic benefits as a result of past transactions or events. (LKAS 37)

LKAS 37 distinguishes provisions from other liabilities such as trade payables and accruals. This is on the basis that for a provision, there is **uncertainty** about the timing or amount of the future payment.

## 1.3 Recognition of provisions

A provision is recognised in the financial statements when all of the following criteria are met.

- (a) There is a present obligation as a result of a past event.
- (b) It is probable that a transfer of economic benefits will be required to settle the obligation.
- (c) A reliable estimate can be made of the obligation.

Each of these conditions is considered in more detail below.

### 1.3.1 Present obligation as a result of a past event

A present obligation as a result of a past event is an obligation that exists at the reporting date as a result of an event that has already occurred. The requirement for the obligation to be the result of a past event means that provisions cannot be made to reflect the future intentions of an entity.

LKAS 37 states that the present obligation can be legal or constructive.

- A legal obligation is an obligation that derives from a contract, legislation or other operation of the law.
- A constructive obligation is defined in LKAS 37 as 'An obligation that derives from an entity's actions where:
  - By an established pattern of past practice, published policies or a sufficiently specific current statement the entity has indicated to other parties that it will accept certain responsibilities; and
  - As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.'



#### QUESTION

#### Present obligation

In which of the following circumstances is there a present obligation as a result of a past event?

- (a) On 13 December 20X9 the board of an entity decided to close down a division. The accounting date of the company is 31 December. Before 31 December 20X9, the decision was not communicated to any of those affected and no other steps were taken to implement the decision.
- (b) During the year ended 31 March 20X4, a company sold a mobile phone with a one-year warranty. On 18 February 20X4, the customer informed the company that the phone would not charge.
- (c) An oil company is not legally obliged to make good environmental damage caused by drilling; however, the company advertises itself as 'ultra-environmentally conscious: one of the greenest companies in Sri Lanka'.
- (d) A company intends to carry out future expenditure to operate in a particular way in the future.

#### ANSWER

- (a) At 31 December 20X9, there is no present obligation, legal or constructive as the decision has not been communicated. (If it had, there would be a constructive obligation.)

- (b) At 31 March 20X4, the company has a present legal obligation to mend the phone under the warranty agreement. This is the result of a past event (the sale of the phone).
- (c) The oil company has created a present constructive obligation by promoting itself as environmentally friendly. This creates an expectation on the part of other parties that it will accept the responsibility of making good the environmental damage.
- (d) There is no present obligation, legal or constructive. This is because the entity could avoid the intended future expenditure.

In some cases, it is not clear whether a past event has given rise to a present obligation. For example, in the case of a lawsuit, it may be disputed whether certain events have occurred and whether those events result in a present obligation.

Where this is the case, management must consider whether it is **more likely than not** that a present obligation as a result of a past event exists. In order to assess this, they must consider **all available evidence** and, if relevant, **the opinion of experts** in order to assess whether there is a present obligation as a result of a past event.

### 1.3.2 Probable transfer of economic benefits

For the purpose of LKAS 37, a transfer of economic benefits is regarded as '**probable**' if the event is **more likely than not** to occur. This appears to indicate a probability of more than 50%. However, the standard makes it clear that where there is a number of similar obligations, the probability should be based on considering the population as a whole, rather than one single item.

### 1.3.3 Reliable estimate

The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. LKAS 37 states that in all but extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

In the very rare cases where a reliable estimate cannot be made, the liability which is not recognised must be disclosed as a contingent liability (see Section 2).

### 1.3.4 Accounting entry to recognise a provision

A provision is initially recognised in the financial statements by:

DEBIT	Expense	X
CREDIT	Provision	X

The provision is increased or decreased in subsequent years (provided that the recognition criteria are still met) and the corresponding entry is charged or credited to profit or loss.

## 1.4 Measurement of provisions

The amount recognised as a provision should be the **best estimate** of the expenditure required to settle the present obligation at the end of the reporting period.

### 1.4.1 Single obligation

Where a provision relates to just one item, all possible outcomes should be considered. The best estimate of the expenditure will normally be the most likely outcome, however:

- If all other possible outcomes are mostly higher, the best estimate will be a higher amount.
- If all other possible outcomes are mostly lower, the best estimate will be a lower amount.

### 1.4.2 Large population of items

When a provision is needed that involves a lot of items, then the provision is calculated using the **expected value approach**. The expected value approach takes each possible outcome and weights it according to the probability of that outcome happening.



#### QUESTION

#### Expected values

Thennakoon Stores (Pvt) Ltd sells sewing machines with a warranty under which customers are covered for the cost of repairs of any manufacturing defect that becomes apparent within the first six months of purchase. The company's past experience and future expectations indicate the following pattern of likely repairs. Thennakoon sold 8,000 machines covered by the warranty in the final six months of 20X4.

<i>% of goods sold</i>	<i>Defects</i>	<i>Average cost of repairs Rs</i>
80	None	–
17	Minor	270
3	Major	780

**Required**

What should be the warranty provision in Thennakoon Stores (Pvt) Ltd's financial statements at 31 December 20X4?

**ANSWER**

Thennakoon Stores should provide on the basis of the **expected cost** of the repairs under warranty.

The expected cost is calculated as  $(80\% \times 8,000 \times \text{Rs. nil}) + (17\% \times 8,000 \times \text{Rs. 270}) + (3\% \times 8,000 \times \text{Rs. 780}) = \text{Rs. 400,000}$ .

Thennakoon Stores should include a provision of Rs. 554,400 in the financial statements.

**1.4.3 Discounting**

Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditure required to settle the obligation. An appropriate discount rate should be used.

The discount rate should be a pre-tax rate that reflects current market assessments of the time value of money. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

**1.4.4 Example: discounting**

Nikatenna PLC knows that when it ceases a certain operation in five years' time, it will have to pay environmental decontamination costs of Rs. 50m.

The provision to be made now will be the present value of Rs. 50m in five years' time.

The relevant discount rate in this case is 10%.



Therefore a provision will be made for:

	Rs
Rs. $50\text{m} \times 1/1.10^5$	31,046,066
DEBIT Decontamination expense	31,046,066
CREDIT Provision for decontamination	31,046,066

The following year, the provision will be wound up by one year's interest.

Rs $31,046,066 \times 10\%$	3,104,607
DEBIT Finance cost	3,104,607
CREDIT Provision for decontamination	3,104,607

The provision will therefore be recognised at Rs. 34,150,673 ( $31,046,066 + 3,104,607$ ) at the end of the second year.

#### 1.4.5 Future events

**Future events** that are reasonably expected to occur (eg new legislation and changes in technology) may affect the amount required to settle the entity's obligation and should be taken into account when measuring a provision.

Gains from the expected disposal of assets should not be taken into account in measuring a provision.

### 1.5 Reimbursements

Some or all of the expenditure needed to settle a provision may be expected to be recovered from a third party. If so, the reimbursement should be recognised only when it is virtually certain that reimbursement will be received if the entity settles the obligation.

- The reimbursement should be treated as a separate asset, and the amount recognised should not be greater than the provision itself.
- The provision and the amount recognised for reimbursement may be netted off in profit or loss.



#### 1.5.1 Example: reimbursement

Basnayake Confectionery PLC is being sued by a customer who claims that goods supplied by the company were substandard and made them ill. Legal counsel has advised Basnayake that the customer has a 90% likelihood of winning the case

against the company, and as a result the company would have to pay Rs. 600,000 in damages.

The goods supplied to the customer were provided by one of Basnayake's suppliers, and the company has also launched a legal claim against that supplier to recover Rs. 750,000 to cover damages payable and loss of reputation. Legal counsel has advised that the counterclaim is virtually certain to succeed if Basnayake loses the case against the customer.

Basnayake should therefore recognise:

- A provision for Rs. 600,000 in respect of the customer claim
- An asset for Rs. 600,000 in respect of the claim against the supplier
- A net amount of nil in profit or loss (since the income and expenditure in relation to the asset and provision are the same amount)

## 1.6 Changes in provisions

Provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that a transfer of resources will be required to settle the obligation, the provision should be reversed.

## 1.7 Use of provisions

A provision should be used only for expenditures for which the provision was originally recognised. Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

## 1.8 Scenarios

As the application of LKAS 37 requires a degree of judgement in its application, the standard provides details of the correct treatment to be applied in a number of situations.

### 1.8.1 Future operating losses

Provisions should not be recognised for future operating losses. They do not meet the definition of a liability and the general recognition criteria set out in the standard.

### 1.8.2 Onerous contracts

An onerous contract is a contract in which the unavoidable costs of fulfilling the terms of the contract exceed the benefit to be gained from the contract.

If an entity has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision.



### 1.8.3 Example: onerous contract

Rupasinghe (Pvt) Ltd signed a 10-year non-cancellable lease for a manufacturing unit on 1 May 20X0. The terms of the lease require an annual rental payment in arrears of Rs. 120,000. On 1 May 20X6, the company vacated the property as a result of a change in strategic direction.

In this case, Rupasinghe is still contracted to pay another four years' rent at Rs. 120,000. As the contract has become onerous, the company should provide for the future costs of Rs. 480,000 on 1 May 20X6 and recognise the associated expense immediately.

### 1.8.4 Restructuring

A restructuring may include:

- (a) The sale or termination of a line of business
- (b) The closure of business locations in a geographical area or the relocation of business activities from one area to another
- (c) Changes in management structure
- (d) Fundamental reorganisations that have a material effect on the nature and focus of the entity's operations

In the case of a restructuring, a provision for associated costs may only be made when there is a constructive obligation. This is the case when an entity:

- Has a detailed formal plan for the restructuring
- Has raised a valid expectation in those affected by it that it will carry out the restructuring (either by starting to implement the plan or by announcing its main features to affected parties)

In the case of the sale of an operation, there is no obligation until there is a binding sale agreement.

A restructuring provision can include only direct expenditure arising from the restructuring, and not associated with the ongoing activities of the entity.



## QUESTION

## Provisions

The following relates to Alutwewa (Pvt) Ltd.

23 February 20X4	Board make decision to close a division
16 March 20X4	Detailed closure plan approved and published by the Board
17 March 20X4	Redundancy notices sent to relevant staff
31 May 20X4	Division closed

In closing the division, the Board of Alutwewa expected to incur Rs. 5m of costs. These were detailed in the closure plan and included:

- Rs. 1.2m to retrain and relocate certain staff
- Rs. 2m redundancy costs
- Rs. 1.5m to exit the lease relating to the division's premises
- Rs. 300,000 to alter the company's distribution network as a result of the closure

From the date when the Board decided to close the division to the date of closure, the division made losses of Rs. 450,000.

### Required

**Assess** whether Alutwewa should make a provision for restructuring at the year end 31 March 20X4, and if so, for how much.

## ANSWER

The closure of a division is classified as a restructuring, according to LKAS 37.

### *Present obligation as result of past event*

At 31 March 20X4, there is a present constructive obligation, as the detailed plan and redundancy notices have created a valid expectation in the parties affected that the division will close.

### *Probable outflow*

The closure has been announced and therefore the outflow of economic benefits is probable.

### *Reliable estimate*

The Board have made estimates of the costs associated with the closure.

Therefore, the LKAS 37 criteria to make a provision are met.

The provision at 31 March 20X4 should include the following.

	Rs
Redundancy costs	2,000,000
Lease exit	<u>1,500,000</u>
	3,500,000

LKAS 37 prohibits the inclusion of retraining and relocating costs and any investment in new systems or distribution networks, since these relate to the ongoing business. The standard also prohibits making a provision for future operating losses.

## 1.9 Disclosure of provisions

Disclosures required in the financial statements for provisions fall into two parts:

- (a) Disclosure of details of the change in carrying amount of a provision from the beginning to the end of the year, including additional provisions made, amounts used and other movements.
- (b) For each class of provision, disclosure of the background to the making of the provision and the uncertainties affecting its outcome, including:
  - (i) A brief description of the nature of the provision and the expected timing of any resulting outflows relating to the provision.
  - (ii) An indication of the uncertainties about the amount or timing of those outflows and, where necessary, to provide adequate information, the major assumptions made concerning future events.
  - (iii) The amount of any expected reimbursement relating to the provision and whether any asset that has been recognised for that expected reimbursement.



### 1.9.1 Example: disclosure in the financial statements

Below is an example of how a **warranty provision** might be disclosed in the notes to the financial statements.

#### 'Note X: Provisions

	<i>Warranty provision Rs'000</i>
At 1 April 20X6	150
Increase in the provision during the year	60
Amounts used during year	<u>(75)</u>
At 31 March 20X7	<u>135</u>

The warranty provision relates to estimated claims on those products sold in the year ended 31 March 20X7 which come with a three-year warranty. The expected value method is used to provide a best estimate. It is expected that the expenditure will be incurred in the next three years.'

What the above table shows is that, at the end of last year, a provision of Rs. 150,000 had been made. During the year, Rs. 75,000 was paid out in warranty costs. At the end of the year, the company estimated that a provision of Rs. 135,000 was needed. The increase in the provision during the year of Rs. 60,000 is the charge to profit or loss for the year.

### 1.9.2 Non-disclosure

LKAS 37 permits reporting entities to avoid disclosure requirements relating to provisions (and contingent liabilities and contingent assets) if they would be expected to **seriously prejudice** the position of the entity in dispute with other parties. However, this should only be employed in **extremely rare** cases. Details of the general nature of the provision/contingencies must still be provided, together with an explanation of why it has not been disclosed.

### 1.10 IFRIC 6 *Liabilities arising from participating in a specific market – waste electrical and electronic equipment*

IFRIC 6 applies to the manufacturers of certain electrical goods when those manufacturers have to contribute towards the cost of the waste management of decommissioned electronic and electrical equipment supplied to private households.

The interpretation deals in particular with identifying the event that gives rise to a decommissioning liability. It concludes that the event that triggers liability recognition is participation in the market during the measurement period (eg in a given calendar year), rather than the incurrence of costs or the initial sale of the electrical goods.

### **1.11 IFRIC 1 *Changes in existing decommissioning, restoring and similar liabilities***

As we saw in Chapter 5, where an entity acquires or builds an item of property, plant and equipment (PPE), there may be an obligation to dismantle and remove the asset and rectify damage caused by the asset at the end of its useful life. Where this is the case, the entity should make a provision for the present value of the dismantling or rectification costs.

IFRIC 1 deals with accounting for changes to such a provision as a result of:

- A change to the estimated cash flows required to settle the obligation (timing and amount)
- A change in the discount rate applied to the cash flows

The interpretation concludes that:

- (a) Where the related asset is measured using the cost model, these changes should be capitalised as part of the cost of the asset and depreciated over the remaining useful life of the item.
- (b) Where the related asset is measured using the revaluation model, a change in the value of the liability does not affect the carrying amount of the item, but instead affects the revaluation surplus or deficit on the item. The effect of the change is treated consistently with other revaluation surpluses or deficits, ie a surplus is credited to equity and a deficit recognised in profit or loss.

The interpretation also states that the unwinding of the discount is recognised in profit or loss as a finance cost.

### **1.12 IFRIC 5 *Rights to interests arising from decommissioning, restoration and environmental rehabilitation funds***

In some cases, entities contribute to a fund to reimburse decommissioning, restoration or rehabilitation costs when they are incurred. Such a fund may be set up for the benefit of just one or many contributors.

IFRIC 5 deals with how a contributor should account for its interest in a fund and how an obligation to make additional contributions should be accounted for. It states:

- (a) If an entity recognises a decommissioning obligation and contributes to a fund to pay for the obligation, it should apply SLFRSs to determine whether the fund should be consolidated or equity accounted (see Chapters 21 to 24).
- (b) When a fund is not consolidated or equity accounted, and the fund does not relieve the contributor of the requirement to pay decommissioning costs, the contributor should recognise its obligation to pay such costs as a liability and its right to receive reimbursement from the fund as a reimbursement under LKAS 37 (see Section 1.5).
- (c) A right to reimbursement is measured at the lower of the decommissioning obligation recognised and the contributor's share of the fair value of the net assets of the fund.
- (d) When a contributor has an obligation to make potential additional contributions to the fund, that obligation is a contingent liability within the scope of LKAS 37.

## 2 LKAS 37 – contingent liabilities



**A contingent liability** is not recognised as a liability in the financial statements, but is disclosed unless the possibility of an outflow of economic benefits is **remote**.

### 2.1 Definition

Contingent liabilities are defined as follows.



LKAS 37 defines a **contingent liability** as:

- A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control, or
- A present obligation that arises from past events but is not recognised because:
  - It is not probable that a transfer of economic benefits will be required to settle the obligation, or
  - The amount of the obligation cannot be measured with sufficient reliability



## 2.2 Accounting treatment

Contingent liabilities should not be recognised in financial statements but they should be disclosed in the notes.

## 2.3 Disclosure

Unless the possibility of an outflow of economic benefits is remote, disclose for each contingent liability.

The required disclosures are:

- (a) A brief description of its nature
- (b) An estimate of the financial effect (where practicable)
- (c) An indication of the uncertainties relating to the amount or timing of any outflow
- (d) The possibility of any reimbursement

## 3 LKAS 37 – contingent assets



A **contingent asset** is not recognised as an asset in the financial statements, but is disclosed if it is **probable** that the economic benefits associated with the asset will flow to the entity.

### 3.1 Definition



LKAS 37 defines a **contingent asset** as:

A possible asset that arises from past events, and whose existence will be confirmed by the occurrence of one or more uncertain future events not wholly within the control of the entity.

### 3.2 Accounting treatment

A contingent asset **must not be recognised** in the accounts, but should be **disclosed** if it is **probable** that the economic benefits associated with the asset will flow to the entity.

If the flow of economic benefits associated with the contingent asset becomes **virtually certain**, it should then be **recognised as an asset** in the statement of financial position, as it is no longer a contingent asset.

For example, a company expects to receive damages of Rs. 100,000 and this is virtually certain. **An asset is recognised.** If, however, the company expects to probably receive damages of Rs. 100,000, **a contingent asset is disclosed.**

### 3.3 Disclosure

Where an inflow of economic benefits is **probable**, an entity should disclose:

- (a) A brief description of its nature
- (b) An estimate of the financial effect (where practicable)

## 4 LKAS 10 *Events after the reporting period*



**Events after the reporting period** that provide **additional evidence** of conditions existing at the reporting date require **adjustments** to be made to the assets and liabilities in the financial statements.

### 4.1 Introduction

There is necessarily a period of time between the end of a financial period and the date on which the financial statements are published.

LKAS 10 is concerned with events that arise during this period, and addresses the issue of whether significant events should in fact be reflected in the financial statements, even though they occurred after the period end.

The rationale behind this argument is that the financial statements are significant indicators of the success of a company or its failure. It is therefore important that they include all the information necessary for an understanding of financial position.

### 4.2 Definitions

The standard gives the following definition.



**Events after the reporting period** are those events, both favourable and unfavourable, that occur between the reporting date and the date on which the financial statements are authorised for issue. Two types of events can be identified:

- Those that provide further evidence of conditions that existed at the reporting date
  - Those that are indicative of conditions that arose subsequent to the reporting date
- (LKAS 10)

### 4.2.1 Date on which financial statements are authorised for issue

The date on which the financial statements are authorised for issue may not be clear. For the avoidance of doubt, LKAS 10 clarifies when the date is in three specific circumstances:

- (a) If an entity is required to submit its financial statements to its shareholders for approval after the financial statements have been issued, the financial statements are authorised for issue on the date of issue, not the date when the shareholders approve the financial statements.
- (b) If the management of an entity is required to issue its financial statements to a supervisory board for approval, the financial statements are authorised for issue when the management authorises them for issue to the supervisory board.
- (c) The date on which the financial statements are authorised for issue is not brought forward as a result of a public announcement of profit or other selected financial information.

### 4.3 Adjusting events

Adjusting events are those events that provide further evidence of conditions that existed at the reporting date. The financial statements are adjusted to reflect these events.

LKAS 10 provides examples of adjusting events including the following.

- The settlement after the reporting period of a court case that confirms that the entity had a present obligation at the end of the reporting period
- The receipt of information after the reporting period indicating that a non-current asset was impaired at the end of the reporting period
- The bankruptcy of a customer that occurs after the reporting period
- The determination after the reporting period of the cost of assets purchased before the end of the reporting period
- The determination after the reporting period of the amount of bonus or profit-sharing payments (if the entity had a present legal or constructive obligation to make such payments at the period end as a result of events before that date)
- The discovery of fraud or errors showing that the financial statements are incorrect

## 4.4 Non-adjusting events

Non-adjusting events are those events that are indicative of conditions that arose subsequent to the reporting date. The financial statements are not adjusted to reflect these events.

Again, LKAS 10 provides a number of examples of non-adjusting events:

- A decline in the fair value of investments between the end of the reporting period and the date when the financial statements are authorised for issue, where the decline reflects circumstances that arose after the reporting date
- A major business combination after the reporting period or disposing of a major subsidiary
- Announcing a plan to discontinue an operation
- Major purchases or disposals of assets
- The destruction of a property by fire
- Abnormally large changes after the reporting period in asset prices
- Changes in tax rates or tax laws enacted or announced after the reporting period that have a significant effect on current and deferred tax amounts in the financial statements
- Entering into significant commitments or contingent liabilities
- Commencing major litigation arising solely out of events that occurred after the reporting period

Although the financial statements are not adjusted to reflect these events, material non-adjusting events should be disclosed (see Section 4.6).

### 4.4.1 Dividends

The declaration of an ordinary dividend, in the period between the reporting date and the date on which the financial statements are authorised for issue, is a non-adjusting event, and no liability should be recognised.

The dividend should, however, be disclosed in accordance with LKAS 1 *Presentation of financial statements*.

**QUESTION****Events after the reporting period**

For each of the following **state** whether the event is adjusting or non-adjusting.

- 1 Announcing or commencing a major restructuring
- 2 The classification of an asset as held for sale
- 3 The sale of inventories for less than their carrying amount after the reporting period
- 4 The determination of the proceeds of a property sold before the reporting date
- 5 A bonus issue after the reporting period

**ANSWER**

- 1 Non-adjusting
- 2 Non-adjusting
- 3 Adjusting
- 4 Adjusting
- 5 Non-adjusting

In all instances, the non-adjusting events do not provide evidence of conditions that existed at the reporting date.

**4.5 Going concern**

If the management of a company determine after the reporting period that it intends to liquidate the company or to cease trading, or that it has no realistic alternative but to do so, this is classified as an adjusting event.

In this case, the basis of accounting should be changed and the financial statements should not be prepared on the going concern basis.

**4.6 Disclosure**

LKAS 10 requires disclosure in respect of:

- The date on which the financial statements were authorised for issue and who gave that authorisation
- Material non-adjusting events

The standard also requires that where a company receives information after the reporting period about conditions that existed at the end of the reporting period, it must update disclosures that relate to those conditions in the light of the new information.

#### **4.6.1 Material non-adjusting event disclosure**

For each material category of non-adjusting event after the reporting period, the following should be disclosed:

- (a) The nature of the event
- (b) An estimate of its financial effect or a statement that such an estimate cannot be made



## CHAPTER ROUNDUP

- ↪ A **provision** is a liability of uncertain timing or amount.
- ↪ A **contingent liability** is not recognised as a liability in the financial statements, but is disclosed unless the possibility of an outflow of economic benefits is **remote**.
- ↪ A **contingent asset** is not recognised as an asset in the financial statements, but is disclosed if it is **probable** that the economic benefits associated with the asset will flow to the entity.
- ↪ **Events after the reporting period** that provide **additional evidence** of conditions existing at the reporting date require **adjustments** to be made to the assets and liabilities in the financial statements.


**PROGRESS TEST**

- 1 A provision is a \_\_\_\_\_ of \_\_\_\_\_ timing or amount.
- 2 At what amount should a provision be measured when a single obligation is being measured?
- 3 A programme is undertaken by management which converts the previously wholly owned chain of restaurants they ran into franchises. Is this restructuring?
- 4 Define contingent asset.
- 5 What distinguishes an adjusting event after the reporting period from a non-adjusting event?
- 6 A customer has brought a legal case against Dias Perera PLC in respect of faulty goods. At 31 December 20X4 the case has not concluded, and lawyers advise the company that there is a 60% chance of them losing the case, in which case payment of Rs. 250,000 is the most likely outcome. The case was settled between 31 December and the date on which the financial statements were approved for issue, and Dias Perera was required to pay Rs. 210,000 to the customer.

What amount, if any, is reported in the published financial statements as a provision at 31 December 20X4?

- A Nil
  - B Rs. 150,000
  - C Rs. 210,000
  - D Rs. 250,000
- 7 Under new legislation, a company is required to fit carbon monoxide detectors in all work areas by 30 October 20X5. To do so would cost Rs. 300,000. At the year end, 31 December 20X5, the company has not fitted the detectors. There is a fine for non-compliance of Rs. 150,000.

What provision, if any, is required at 31 December 20X5?

- A No provision
- B A provision for Rs. 150,000
- C A provision for Rs. 300,000
- D A provision for Rs. 450,000



- 8** During the period between the reporting date and the date on which the financial statements of Kalugala Tea (Pvt) Ltd are approved for issue, the following events occur.

- 1 A fire at one of the 10 plantations
- 2 A management decision to pay a one-off bonus of Rs. 60,000 to key members of staff in respect of performance in the past year

Which of these is an adjusting event?

- A Neither of them
- B 1 only
- C 2 only
- D Both of them

## ANSWERS TO PROGRESS TEST

- 1 A provision is a liability of uncertain timing or amount.
- 2 At the best estimate of the expenditure. This will normally be the most likely outcome.
- 3 Yes, the nature of the business's operations has changed.
- 4 A possible asset that arises from past events and whose existence will be confirmed by the occurrence of one or more uncertain future events not wholly within the control of the entity.
- 5 An adjusting event provides evidence of conditions at the reporting date, whereas a non-adjusting event is indicative of conditions that arose subsequent to the reporting date.
- 6 The answer is **C**. A provision should be made, as there is a present legal obligation as a result of a past event; a transfer of economic resources is probable and can be reliably measured.

The amount initially recognised at 31 December would be the best estimate of Rs. 250,000; however, the subsequent settlement of the case is an adjusting event and so in the published financial statements the provision will be Rs. 210,000.

- 7 The answer is **B**. There is no obligation for the costs of fitting the detectors, since the detectors have not been fitted. Therefore, no provision is required in respect of the Rs. 300,000 cost of fitting the detectors.

There is, however, an obligation to pay a Rs. 150,000 fine, since the obligating event has occurred (non-compliance of the factory).

- 8 The answer is **A**. The fire in itself is a non-adjusting event. If it affects going concern, it may become an adjusting event; however, since there are a further nine plantations, this is probably not the case.

The decision to pay a bonus is also a non-adjusting event, as the bonus is not contractual and the company has no obligation to pay it.

# Revenue

## INTRODUCTION

LKAS 18 provides guidance on when revenue should be recognised and how it should be measured. This standard was introduced at the KE 1 level. It is supplemented by guidance in five Interpretations:

- IFRIC 12 *Service concession arrangements*
- IFRIC 13 *Customer loyalty programmes*
- IFRIC 15 *Agreements for the construction of real estate*
- IFRIC 18 *Transfers of assets from customers*
- SIC 31 *Revenue – barter transactions involving advertising services*

Knowledge Component			
2	Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)		
2.1	Level A	2.1.1	Advise on the application of Sri Lanka Accounting standards in solving complicated matters.
		2.1.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in conformity with Sri Lanka Accounting Standards.
		2.1.3	Evaluate the impact of application of different accounting treatments.
		2.1.4	Propose appropriate accounting policies to be selected in different circumstances.

Knowledge Component		
2.2 <b>Level B</b>	2.1.5	Evaluate the impact of use of different expert inputs to financial reporting.
	2.1.6	Advise on the appropriate application and selection of accounting/reporting options given under standards.
	2.1.7	Design the appropriate disclosures to be made in the financial statements.
	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
	2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
	2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
	2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
	2.2.5	Outline the disclosures to be made in the financial statements.

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1 Introduction and definitions	2.2
2 Measurement and recognition	2.2
3 Practical applications	2.2
4 Disclosure	2.2
5 Related IFRICs	2.2

**LKAS 18 Learning objectives**

- Explain revenue, and the criteria to be satisfied to recognise revenue from sale of goods and rendering of services.
- Recognise basis used to measure revenue.
- Compute revenue from sale of goods and rendering of services.
- Explain the accounting treatment with regard to recognition of revenue from interest, dividends and royalties.
- Outline the disclosures to be made in respect of revenue.

**1 Introduction and definitions**

**LKAS 18 Revenue provides guidance on the measurement of revenue and when it should be recognised.**

LKAS 18 governs the recognition of revenue in specific (common) types of transaction. Generally, recognition should be when it is probable that **future economic benefits** will flow to the entity and when these benefits can be **measured reliably**.

Income, as defined by the Conceptual Framework, includes both revenues and gains. Revenue is income arising in the ordinary course of an entity's activities and it may be called different names, such as sales, fees, interest, dividends or royalties.

**1.1 Scope**

LKAS 18 covers the revenue from specific types of transaction or events.

- **Sale of goods** (manufactured products and items purchased for resale)
- **Rendering of services**
- Use by others of entity assets yielding **interest, royalties and dividends**

Interest, royalties and dividends are included as income because they arise from the use of an entity's assets by other parties.

The Standard specifically **excludes** various types of revenue arising from leases, insurance contracts, changes in value of financial instruments or other current assets, natural increases in agricultural assets and mineral ore extraction.

## 1.2 Definitions



**Revenue** is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

**Interest** is the charge for the use of cash or cash equivalents or amounts due to the entity.

**Royalties** are charges for the use of non-current assets of the entity, eg patents, computer software and trademarks.

**Dividends** are distributions of profit to holders of equity investments, in proportion with their holdings, of each relevant class of capital.

Revenue does not include sales taxes, value added taxes or goods and service taxes which are only collected for third parties, because these do not represent an economic benefit flowing to the entity. The same is true for revenues collected by an agent on behalf of a principal. Revenue for the agent is only the commission received for acting as an agent.

## 2 Measurement and recognition



**Revenue is measured at the fair value of consideration received and recognised when the LKAS 18 criteria are met.**

### 2.1 Measurement

When a transaction takes place, the amount of revenue is measured as the fair value of the consideration received, which will take account of any trade discounts and volume rebates.

#### 2.1.1 Deferred receipt

When the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest free credit to the buyer. When the

arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest.

The difference between the fair value of the consideration and the nominal amount of the consideration is recognised as interest revenue.

### 2.1.2 Exchange of goods or services

The measurement of revenue where goods or services are exchanged depends on the nature of the goods or services:

- (a) Where goods or services are exchanged for similar goods or services (in nature and value), the exchange is not regarded as a revenue-generating transaction.
- (b) Where goods or services are exchanged for dissimilar goods or services, revenue is measured at the fair value of the goods or services received, adjusted by any cash or cash equivalents transferred.

## 2.2 Recognition

LKAS 18 contains separate recognition criteria for the sale of goods and the rendering of services. It also considers dividends, interest and royalties separately.

### 2.2.1 Sale of goods

Revenue from the sale of goods should only be recognised when **all** these conditions are satisfied.

- (a) The entity has transferred the significant risks and rewards of ownership of the goods to the buyer
- (b) The entity has no continuing managerial involvement to the degree usually associated with ownership, and no longer has effective control over the goods sold
- (c) The amount of revenue can be measured reliably
- (d) It is probable that the economic benefits associated with the transaction will flow to the entity
- (e) The costs incurred in respect of the transaction can be measured reliably

The transfer of risks and rewards can only be decided by examining each transaction. Mainly, the transfer occurs at the same time as either the transfer of

legal title, or the passing of possession to the buyer – this is what happens when you buy something in a shop.

If significant risks and rewards remain with the seller, then the transaction is **not** a sale and revenue cannot be recognised, for example if the receipt of the revenue from a particular sale depends on the buyer receiving revenue from their own sale of the goods.

It is possible for the seller to retain only an 'insignificant' risk of ownership and for the sale and revenue to be recognised. The main example here is where the seller retains title only to ensure collection of what is owed on the goods. This is a common commercial situation, and when it arises the revenue should be recognised on the date of sale.

The probability of the entity receiving the revenue arising from a transaction must be assessed. It may only become probable that the economic benefits will be received when an uncertainty is removed, for example government permission for funds to be received from another country. Only when the uncertainty is removed should the revenue be recognised. This is in contrast with the situation where revenue has already been recognised but where the collectability of the cash is brought into doubt. Where recovery has ceased to be probable, the amount should be recognised as an expense, **not** an adjustment of the revenue previously recognised. These points also refer to services and interest, royalties and dividends below.

Matching should take place, ie the revenue and expenses relating to the same transaction should be recognised at the same time. It is usually easy to estimate expenses at the date of sale (eg warranty costs and shipment costs). Where they cannot be estimated reliably, then revenue cannot be recognised; any consideration that has already been received is treated as a liability.

### 2.2.2 Rendering of services

When the outcome of a transaction involving the rendering of services can be estimated reliably, the associated revenue should be recognised by reference to the stage of completion of the transaction at the end of the reporting period. The outcome of a transaction can be estimated reliably when **all** these conditions are satisfied.

- (a) The amount of revenue can be measured reliably
- (b) It is probable that the economic benefits associated with the transaction will flow to the entity
- (c) The stage of completion of the transaction at the end of the reporting period can be measured reliably



- (d) The costs incurred for the transaction and the costs to complete the transaction can be measured reliably

The parties to the transaction will normally have to agree the following before an entity can make reliable estimates.

- (a) Each party's enforceable rights regarding the service to be provided and received by the parties
- (b) The consideration to be exchanged
- (c) The manner and terms of settlement

There are various methods of determining the stage of completion of a transaction, but for practical purposes, when services are performed by an indeterminate number of acts over a period of time, revenue should be recognised on a straight line basis over the period, unless there is evidence for the use of a more appropriate method. If one act is of more significance than the others, then the significant act should be carried out **before** revenue is recognised.

In uncertain situations, when the outcome of the transaction involving the rendering of services cannot be estimated reliably, the standard recommends a no loss/no gain approach. Revenue is recognised only to the extent of the expenses recognised that are recoverable.

This is particularly likely during the early stages of a transaction, but it is still probable that the entity will recover the costs incurred. So the revenue recognised in such a period will be equal to the expenses incurred, with no profit.

Obviously, if the costs are not likely to be reimbursed, then they must be recognised as an expense immediately. When the uncertainties cease to exist, revenue should be recognised as laid out in the first paragraph of this section.

### 2.2.3 Bundled package of goods and services

The sales price of a product may include an identifiable amount for an ongoing service ('a bundle'). In this case, the revenue related to the product and the service must be unbundled and recognised separately according to the recognition criteria for sale of goods and rendering of services.

The amount of revenue deemed to relate to the services provided should cover the cost of those services together with a reasonable profit.

### 2.2.4 Interest, dividends and royalties

When others use the entity's assets yielding interest, royalties and dividends, the revenue should be recognised on the bases set out below when:

- (a) It is probable that the economic benefits associated with the transaction will flow to the entity
- (b) The amount of the revenue can be measured reliably

The revenue is recognised on the following bases.

- (a) Interest is recognised on a time proportion basis that takes into account the effective yield on the asset
- (b) Royalties are recognised on an accruals basis in accordance with the substance of the relevant agreement
- (c) Dividends are recognised when the shareholder's right to receive payment is established

The effective yield on an asset mentioned above is the rate of interest required to discount the stream of future cash receipts expected over the life of the asset to equate to the initial carrying amount of the asset.

Royalties are usually recognised on the same basis that they accrue under the relevant agreement. Sometimes the true substance of the agreement may require some other systematic and rational method of recognition.

Once again, the points made above about probability and collectability on sale of goods also apply here.



## QUESTION

## Revenue recognition

The following scenarios relate to separate companies.

- 1 A company sells a washing machine for Rs. 500 with a one-year warranty. The dealer knows from experience that 15% of these machines develop a fault in the first year and that the average cost of repair is Rs. 100. He sells 200 machines. How does he account for this sale?
- 2 A computerised accountancy package is sold with one year's after sales support. The cost of providing support to one customer for one year is calculated to be Rs. 50. The company has a mark-up on cost of 15%. The product is sold for Rs. 350.
- 3 A company sells a sofa on 1 January 20X3 for Rs. 3,000 with two years' interest free credit. Interest on similar deals is normally 15%. The company's year end is 31 December.

### Required

**Advise** how much revenue is recognised in each case and when.

**ANSWER**

1 The company will recognise revenue of Rs. 100,000 ( $\text{Rs. } 500 \times 200$ ) and an associated provision of Rs. 3,000 ( $\text{Rs. } 100 \times 200 \times 15\%$ ) when the LKAS 18 recognition criteria for sale of goods are met.

2 Rs. 57.50 ( $50 + (50 \times 15\%)$ ) is recognised as deferred income and released to profit or loss over the course of the year.

The remaining Rs. 292.50 is recognised as revenue immediately.

3 The revenue is discounted to its present value:

$$\text{Rs. } 3,000 \times 1/1.15^2 = \text{Rs. } 2,268$$

This is recognised as revenue on delivery of the sofa (assuming all other recognition criteria are met at this stage).

The Rs. 732 remaining amount is recognised as finance income in each of the two years of credit. In Year 1, finance income is Rs. 340 ( $15\% \times 2,268$ ); in Year 2, finance income is Rs. 392 ( $15\% \times (2,268 + 340)$ ).

### 3 Practical applications



**A number of examples of the application of the requirements of the standard are provided in the appendix to LKAS 18.**

Revenue recognition is an area of accounting where significant judgement must be applied. As a result, and in order to assist the preparers of financial statements, LKAS 18 provides a number of examples of the application of the recognition criteria.

#### 3.1 Bill and hold sales

A bill and hold sale is a sale in which the buyer accepts legal title and billing for a purchased item, but requests that delivery is delayed.

Here, revenue is recognised when the buyer takes title, provided that:

- (a) It is probable that delivery will be made
- (b) The goods are available for delivery
- (c) The buyer acknowledges delayed delivery
- (d) Normal payment terms apply

### 3.2 Consignment sales/sale or return

A consignment sale arises where Company A sells goods to Company B and Company B undertakes to sell the goods on to a third party on behalf of Company A. Company A usually retains legal title until the onward sale occurs. If the onward sale does not occur, often the goods may be returned to Company A.

In this situation, Company A does not recognise a sale until Company B makes an onward sale to a third party. This is because the risks and rewards of ownership are not deemed to have transferred until this occurs.

### 3.3 Sale and repurchase

In a sale and repurchase transaction, one party sells an asset to another, but the terms of the sale allow the seller to repurchase the asset at a later date under certain conditions.

These arrangements are accounted for in accordance with their commercial substance rather than legal form. Therefore, the sale is only recorded where the risks and rewards of ownership have transferred and the agreement is not, effectively a form of secured loan.

For example, a whisky distillery will commonly sell its maturing vats of whisky to a bank with an option to repurchase them when mature. The whisky remains on distillery premises throughout. This is a secured loan arrangement and should not be accounted for as a sale and repurchase.

## 4 Disclosure



LKAS 18 requires that revenue disclosed in the statement of profit or loss is analysed in the notes to the financial statements.

The following items should be disclosed.

- (a) The accounting policies adopted for the recognition of revenue, including the methods used to determine the stage of completion of transactions involving the rendering of services
- (b) The amount of each significant category of revenue recognised during the period including revenue arising from:
  - (i) The sale of goods
  - (ii) The rendering of services
  - (iii) Interest
  - (iv) Royalties
  - (v) Dividends

- (c) The amount of revenue arising from exchanges of goods or services included in each significant category of revenue

Any contingent gains or losses, such as those relating to warranty costs, claims or penalties should be treated according to LKAS 37 *Provisions, contingent liabilities and contingent assets* (Chapter 11).

## 5 Related IFRICs



**Five Interpretations relate to revenue recognition; they are IFRIC 12, IFRIC 13, IFRIC 15, IFRIC 18 and SIC 31.**

### 5.1 IFRIC 12 *Service concession arrangements*



**A service concession arrangement** is an arrangement whereby a government or other body grants contracts for the supply of public services – such as roads, energy distribution, prisons or hospitals – to private operators.

Two types of service concession agreement exist:

- (1) One in which the operator has a contractual right to receive cash or another asset from the Government
- (2) One in which the operator has the right to charge for access to the public sector that it constructs or upgrades

#### 5.1.1 Accounting for service concession arrangements

In the first type of arrangement, the operator should recognise a financial asset measured at fair value to the extent that it has an unconditional contractual right to receive cash or another financial asset from (or at the discretion of) the Government/grantor.

This is the case where the government/grantor contractually guarantees to pay the operator specified or determinable amounts or the shortfall (if any) between the amount received from users of the public service and a specified or determinable amount.

In the second type of arrangement, the operator should recognise an intangible asset measured at fair value to the extent it receives a licence to charge users of the public service.

### 5.1.2 Operating revenue

The service concession arrangement operator should recognise and measure revenue in accordance with LKAS 11 and 18 for the service it performs.

## 5.2 IFRIC 13 *Customer loyalty programmes*

A customer loyalty programme is a programme whereby customers who buy goods or services are awarded credits. These may be reward points or travel miles, for example, and can be redeemed in the future for free/discounted goods and services.

IFRIC 13 deals with the accounting treatment applied to customer loyalty programmes. It requires that the proceeds of a sale in which reward points/credits are awarded is split into:

- (1) Revenue
- (2) Deferred revenue associated with the reward points/credits

The proceeds recognised as deferred revenue are measured by reference to the fair value of the rewards/credits awarded, taking into account:

- (a) The discounts or incentives that would be offered to customers who have not earned reward points/credits from an initial sale
- (b) The proportion of reward points/credits that are not expected to be redeemed by customers
- (c) If customers can choose their award, the fair values of the range of available awards weighted in proportion to the frequency with which each award is expected to be selected

The deferred revenue is recognised as revenue when the issuing entity has fulfilled its obligations by supplying the awards or paying another party to do so.

## 5.3 IFRIC 15 *Agreements for the construction of real estate*

IFRIC 15 addresses:

- (a) Whether an agreement for the construction of real estate is within the scope of LKAS 11 or LKAS 18
- (b) When revenue from the construction of real estate is recognised

In particular, it standardises accounting for revenue by real estate developers for sales of units before construction is complete.

### 5.3.1 LKAS 11 or LKAS 18?

IFRIC 15 states that LKAS 11 is applied when the definition of a construction contract is met. This is the case when the buyer can specify:

- (a) The major structural elements of the design of the real estate before construction commences
- (b) Major structural changes once construction is in progress

If construction could take place independently of the agreement and buyers only have limited ability to influence the design of the real estate, the agreement is within the scope of LKAS 18.

### 5.3.2 Accounting treatment

When a contract is within the scope of LKAS 11, the requirements of LKAS 11 are followed, ie revenue is recognised by reference to stage of completion.

When a contract is within the scope of LKAS 18, it may be for the rendering of services or provision of goods. It is for the rendering of services where, for example, the customer enters into several agreements with different entities relating to different aspects of the construction, and the entity is responsible only for assembling materials supplied by others. In this case, revenue is recognised by reference to stage of completion.

When a contract is within the scope of LKAS 18 and for the sale of goods (ie the provision of services together with the construction materials), the 'sale of goods' recognition criteria in LKAS 18 apply. IFRIC 15 focuses on the transfer of risks and rewards and distinguishes between whether this transfer occurs at one point in time or over a period of time.

- Where it occurs at one point in time, revenue is recognised only when all of the LKAS 18 criteria are met.
- Where it occurs over a period of time (as construction progresses), the percentage of completion method is applied.

## 5.4 IFRIC 18 *Transfers of assets from customers*

### 5.4.1 The situation

IFRIC 18 deals with the situation in which an entity receives an item of property, plant and equipment (PPE) that it must then use to either connect the customer to a network or to provide the customer with ongoing access to a supply of goods or services (eg water or gas). In some cases, the customer transfers cash to the entity in order to buy or build the necessary item of PPE.

### 5.4.2 The accounting treatment

The basic principle of IFRIC 18 is that when an item of PPE is transferred from a customer, provided that the definition of an asset is met from the recipient's perspective, it must recognise the asset in its accounts.

The deemed cost of the asset is its fair value on the transfer date.

If services are received by the customer in return for the transfer, then the recipient should split the transaction into separate components in accordance with LKAS 18. If only one component is identified, then revenue is recognised when the service is performed (eg when access to a utility network is provided).

### 5.5 SIC 31 Revenue – *barter transactions involving advertising services*

LKAS 18 states that in order to be recognised, revenue must be capable of reliable measurement. SIC 31 deals with the situation where a seller can reliably measure revenue at the fair value of advertising services received or provided in a barter transaction.

SIC 31 states that:

- (a) Revenue from a barter transaction involving advertising cannot be measured reliably at the fair value of advertising services **received**.
- (b) Revenue from a barter transaction involving advertising can be measured reliably at the fair value of advertising services **provided** by reference to non-barter transactions that:

- Involve advertising similar to the advertising in the barter transaction
- Occur frequently

Represent a predominant number of transactions and amount when compared to all transactions to provide advertising that is similar to the advertising in the barter transaction

- Involve cash and/or another form of consideration (such as marketable securities or non-monetary assets) that has a reliably measureable fair value
- Do not involve the same counterparty as in the barter transaction



**CHAPTER ROUNDUP**

- ↳ **LKAS 18 *Revenue* provides guidance on the measurement of revenue and when it should be recognised.**
- ↳ **Revenue is measured at the fair value of consideration received and recognised when the LKAS 18 criteria are met.**
- ↳ **A number of examples of the application of the requirements of the standard are provided in the appendix to LKAS 18.**
- ↳ **LKAS 18 requires that revenue disclosed in the statement of profit or loss is analysed in the notes to the financial statements.**
- ↳ **Five Interpretations relate to revenue recognition; they are IFRIC 12, IFRIC 13, IFRIC 15, IFRIC 18 and SIC 31.**


**PROGRESS TEST**

- 1 How is revenue measured?
- 2 When is revenue not recognised in an exchange transaction?
- 3 What are the recognition criteria for the provision of services?
- 4 What is a bill and hold sale?
- 5 What separate categories of revenue must be disclosed if significant?
- 6 A company sells goods to a customer on credit for Rs. 300,000 after giving a trade discount of Rs. 10,000. The customer also takes advantage of a Rs. 5,000 prompt payment discount. The goods have a fair value of Rs. 320,000.  
How much revenue is recognised?  
 A Rs. 295,000  
 B Rs. 300,000  
 C Rs. 310,000  
 D Rs. 320,000
- 7 Which of the following is not one of the recognition criteria for revenue from the sale of goods?  
 A Costs incurred in respect of the transaction can be measured reliably  
 B All of the risks and rewards of ownership are transferred to the buyer  
 C The amount of revenue can be measured reliably  
 D Probable economic benefits will flow to the seller
- 8 A company awards one reward point for every Rs. 10 that a customer spends. Every 100 points can be redeemed for company goods with a retail price of Rs. 200. What amount of revenue is deferred on a sale of Rs. 1,000 if all reward points are expected to be redeemed?  
 A Rs. 100  
 B Rs. 200  
 C Rs. 800  
 D Rs. 900

## ANSWERS TO PROGRESS TEST

- 1 At the fair value of consideration received or receivable.
- 2 When the goods/services exchanged are similar.
- 3
  - (a) The amount of revenue can be measured reliably
  - (b) It is probable that the economic benefits associated with the transaction will flow to the entity
  - (c) The stage of completion of the transaction at the end of the reporting period can be measured reliably
  - (d) The costs incurred for the transaction and the costs to complete the transaction can be measured reliably
- 4 A sale where the customer accepts legal title and billing but delays delivery
- 5
  - (i) The sale of goods
  - (ii) The rendering of services
  - (iii) Interest
  - (iv) Royalties
  - (v) Dividends
- 6 The answer is **B**. Revenue is measured after trade discounts but before prompt payment discounts. The fair value of goods is irrelevant; revenue is measured at the fair value of consideration received/receivable.
- 7 The answer is **B**. Only significant risks and rewards must be transferred to the buyer.
- 8 The answer is **B**. Each reward point is worth Rs. 200/100 points = Rs. 2  
 100 reward points are awarded (Rs. 1,000/Rs. 10)  
 Therefore, deferred revenue is Rs. 200.



# Income Taxes

## INTRODUCTION

LKAS 12 provides the accounting guidance relevant to income taxes. You have already met this standard at KE1 level. In this chapter, we shall revise KE1 material and add to this, in particular by dealing with more complex scenarios and considering the presentation and disclosure requirements of the standard in more detail.

Knowledge Component			
<b>2</b>	<b>Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)</b>		
<b>2.2</b>	<b>Level B</b>	<b>2.2.1</b>	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		<b>2.2.2</b>	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		<b>2.2.3</b>	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		<b>2.2.4</b>	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		<b>2.2.5</b>	Outline the disclosures to be made in the financial statements.

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1	Introduction	2.2
2	Current tax	2.2
3	Deferred tax	2.2
4	Taxable temporary differences	2.2
5	Deductible temporary differences	2.2
6	Deferred tax assets and liabilities	2.2
7	Taxation in company accounts	2.2

**LKAS 12 Learning objectives**

- Explain the recognition of current tax liabilities and current tax assets.
- Explain the recognition of deferred tax liabilities and deferred tax assets.
- Compute deferred tax liabilities and deferred tax assets.
- Outline the disclosure requirements pertaining to taxes.

**1 Introduction**

**LKAS 12 *Income taxes*** deals with current tax and deferred tax.

LKAS 12 *Income taxes* was introduced at KE1 level. In this chapter, we shall revise the basic requirements of the standard before considering its application to more complex scenarios.

The standard deals with accounting for two types of tax:

- Current tax, being the tax payable on profits in the year (or the tax recoverable on losses in the year)
- Deferred tax, being the tax that may become payable (or recoverable) in the future as a result of assets and liabilities that are recognised in an entity's financial statements now

It is important to remember that while current tax payable is an existing liability to the tax authorities, deferred tax is not. Deferred tax is simply an accounting adjustment.

## 2 Current tax



**Current tax** is the amount payable to the tax authorities in relation to the trading activities of the period.

### 2.1 Definitions



**Current tax** is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

**Taxable profit (tax loss)** is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, on which income taxes are payable (recoverable).

**Accounting profit** is profit or loss for a period before deducting tax expense.

**Tax expense (tax income)** is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

### 2.2 Recognition and measurement of current tax

Tax arising on profits in the period is measured at the amount expected to be paid to the tax authorities and is generally recognised:

- (a) As part of the tax charge to profit or loss
- (b) As a current liability to the extent that it is unpaid at the period end

In Sri Lanka, corporate income tax is payable quarterly in advance on set payment dates, and therefore the year-end liability is unlikely to represent the full amount of tax payable on the year's profits.



#### 2.2.1 Example

The tax accountant of Batticaloa Trading (Pvt) Ltd has calculated the taxable profits of the company to be Rs. 740,000 in the year ended 31 December 20X3. The company pays tax at 28% and has already recorded quarterly payments in respect of the year of Rs. 46,500 in August 20X3 and Rs. 48,350 in November 20X3.

The accounting entries to record current tax amounts are (Rs):

August 20X3	DEBIT	Current tax liability	46,500
	CREDIT	Cash	46,500
November 20X3	DEBIT	Current tax liability	48,350
	CREDIT	Cash	48,350

31 December 20X3	DEBIT	Tax charge ( $740,000 \times 28\%$ )	207,200
	CREDIT	Current tax liability	207,200

Therefore, amounts reported in the financial statements are:

#### Statement of profit or loss

Tax charge	Rs. 207,200
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Statement of financial position

Current tax liability ( $207,200 - 46,500 - 48,350$ )	Rs. 112,350
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### 2.2.2 Over and underprovisions

In the above example, at the year end, Batticaloa Trading (Pvt) Ltd still has two instalments of corporate income tax to make in respect of the year ended 31 December 20X3. Based on the tax charge for the year of Rs. 207,200, this means the company will have a further Rs. 112,350 to pay. Both of these amounts are, however, based on year-end estimates of taxable profit and so they may change before payment of the final instalment is made. Where the tax charged to profit or loss in a given year is not equal to the amount of tax ultimately paid for that year, the tax charge of the following year must be adjusted to compensate for the under or over provision.

- (a) An underprovision arises where the tax paid in respect of profits for a given year exceeds the tax charged to profit or loss for that year.

The amount of the underprovision is added to the following year's tax charge.

- (b) An overprovision arises where the tax paid in respect of profits for a given year is less than the tax charged to profit or loss for that year.

The amount of the overprovision is deducted from the following year's tax charge.

An under or overprovision does not normally affect the current tax **liability** of the following year.

### 2.2.3 Unpaid tax in respect of prior periods

Any unpaid tax in respect of prior periods is included in the year-end current tax liability.



### 2.2.4 Recoverable tax

If the tax paid in respect of current and prior periods exceeds the amount due for those periods, the excess is recognised as an asset.

### 2.2.5 Tax losses

Where tax losses are made and utilised in a period, a tax credit is measured at the amount expected to be recovered from the tax authorities and is generally recognised:

- (a) As a credit within the tax charge to profit or loss
- (b) As a current asset at the period end

In some jurisdictions, corporate tax losses may be carried back to reduce the current tax charge of previous periods. In this case, the benefit of the tax loss carried back is recognised as an asset. This treatment of tax losses is not permitted in Sri Lanka.

### 2.2.6 Recognition of current tax outside profit or loss

As we have seen, the current tax charge (or credit) is generally recognised in profit or loss. If, however, a transaction or event is recognised **directly in equity** (in the same or a different period), then the related tax is also recognised directly in equity.

An example of such a situation is where, under LKAS 8, an adjustment is made to the **opening balance of retained earnings** due to either a change in accounting policy that is applied retrospectively, or the correction of a material prior period error.



#### QUESTION

#### Current tax

Jaffna Supplies (Pvt) Ltd had taxable profits of Rs. 950,000 in 20X8. In the previous year, income tax on profits had been estimated as Rs. 405,000. The corporate income tax rate is 28%.

#### Required

**Calculate** the tax charge to profit or loss for 20X8 if the tax due on 20X7 profits was subsequently settled with the tax authorities as:

- (a) Rs. 380,000
- (b) Rs. 415,000

**ANSWER**

(a)

	Rs
Current tax charge ( $905,000 \times 28\%$ )	253,400
Overprovision in 20X7 ( $405,000 - 380,000$ )	<u>(25,000)</u>
	228,400

(b)

	Rs
Current tax charge ( $905,000 \times 28\%$ )	253,400
Underprovision in 20X7 ( $415,000 - 405,000$ )	<u>10,000</u>
	263,400

**2.3 Presentation of current tax**

In the statement of financial position, **current tax assets and liabilities** should be shown separately from other assets and liabilities.

Current tax assets and liabilities can be **offset**, but this should happen only when certain conditions apply.

- (a) The entity has a **legally enforceable right** to set off the recognised amounts.
- (b) The entity intends to settle the amounts on a **net basis**, or to realise the asset and settle the liability at the same time.

The **tax expense (income)** related to the profit or loss from ordinary activities should be shown in the statement of profit or loss.

**3 Deferred tax**

**Deferred tax** is an accounting measure used to match the future tax effects of transactions with their accounting impact.

**3.1 Definitions**

The following definitions should be familiar from your KE1 studies.



**Deferred tax liabilities** are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

**Deferred tax assets** are the amounts of income taxes recoverable in future periods in respect of:

- (a) Deductible temporary differences
- (b) The carry forward of unused losses
- (c) The carry forward of unused tax credits

**Temporary differences** are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either:

- (a) **Taxable temporary differences**, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.
- (b) **Deductible temporary differences**, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

**The tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes.

### 3.2 Purpose of deferred tax

Deferred tax compensates for temporary differences between taxable and accounting profits and attempts to match the tax impact of a transaction to the accounting impact for the purposes of financial reporting, so that both are reported in the same period.

For example:

- (a) If a provision for a future expense is made in the current accounting period, but the expense is not tax allowable until paid, a deferred tax adjustment will result in tax relief being recognised as deferred tax income in the statement of profit or loss in the current period alongside the expense.
- (b) If an entity buys an asset and depreciates it over ten years but 100% tax relief is given immediately, a deferred tax adjustment will result in tax relief being delayed in the statement of profit or loss and spread over the ten-year depreciation period.

A deferred tax charge or credit will therefore form an additional element of the tax charge for the year alongside the current year tax charge and any under or overprovision for the previous year.

### 3.3 Approach to deferred tax

LKAS 12 takes a 'balance sheet' approach to deferred tax, calculating temporary differences based on the accounting and tax carrying amounts of the underlying assets or liabilities.

The steps to calculate deferred tax amounts for inclusion in the financial statements are:

- (1) Calculate the tax base of the underlying asset or liability.
- (2) Calculate the temporary difference as the difference between carrying amount and tax base.
- (3) Apply the relevant tax rate to calculate the deferred tax asset or liability.
- (4) Record the overall deferred tax asset or liability.

### 3.4 Tax base

The definition of the tax base was covered in some detail at KE1 level. As it is so important to the calculation of deferred tax, this detail together with examples are provided below.

Remember that some items do have a tax base even though they are not recognised as assets and liabilities in the statement of financial position.

#### 3.4.1 Tax base of an asset

- (a) The **tax base of an asset** is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to the entity when it recovers the carrying amount of the asset.
- (b) Where those economic benefits are not taxable, the tax base of the asset is the same as its carrying amount.



#### QUESTION

#### Tax base of an asset

**State** the tax base of each of the following assets and any temporary difference arising.

- (a) A machine cost Rs. 10,000 and has a carrying amount of Rs. 8,000. For tax purposes, depreciation of Rs. 3,000 has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal. Revenue generated by using the machine is taxable, any gain on disposal of the

machine will be taxable and any loss on disposal will be deductible for tax purposes.

- (b) Interest receivable has a carrying amount of Rs. 1,000. The related interest revenue will be taxed on a cash basis.
- (c) Prepaid rental expenses have a carrying amount of Rs. 3,000. Tax relief was given for the rental expenses when paid.
- (d) Undepreciated land that originally cost Rs. 3m has been impaired by Rs. 800,000. The impairment loss is not recognised for tax purposes until the land is sold.
- (e) A loan receivable has a carrying amount of Rs. 1m. The repayment of the loan will have no tax consequences.

### ANSWER

- (a) The tax base of the machine is Rs. 7,000.
- (b) The tax base of the interest receivable is nil.
- (c) The tax base of the prepayment is nil.
- (d) The tax base of the land is Rs. 3m.
- (e) The tax base of the loan is Rs. 1m.

### 3.4.2 Tax base of a liability

- (a) The tax base of a liability is its carrying amount less any amount that is deducted for tax purposes in relation to the liability in future periods.
- (b) For revenue received in advance, the tax base of the resulting liability is its carrying amount less any amount of revenue that will not be taxable in future periods.



### QUESTION

#### Tax base of a liability

**State** the tax base of each of the following liabilities and any resulting temporary difference.

- (a) Current liabilities include accrued expenses with a carrying amount of Rs. 1,000. The related expense will be deducted for tax purposes on a cash basis.
- (b) Current liabilities include interest revenue received in advance, with a carrying amount of Rs. 10,000. The related interest revenue was taxed on a cash basis.

- (c) Current liabilities include accrued expenses with a carrying amount of Rs. 2,000. The related expense has already been deducted for tax purposes.
- (d) Current liabilities include accrued fines and penalties with a carrying amount of Rs. 100. Fines and penalties are not deductible for tax purposes.
- (e) A loan payable has a carrying amount of Rs. 1m. The repayment of the loan will have no tax consequences.

### ANSWER

- (a) The tax base of the accrued expenses is nil.
- (b) The tax base of the interest received in advance is nil.
- (c) The tax base of the accrued expenses is Rs. 2,000.
- (d) The tax base of the accrued fines and penalties is Rs. 100.
- (e) The tax base of the loan is Rs. 1m.

### 3.4.3 Circumstances where tax base is equal to carrying amount

LKAS 12 gives the following examples of circumstances in which the tax base of an asset or liability will be **equal to its carrying amount**.

- **Accrued expenses** which have already been deducted in determining an entity's current tax liability for the current or earlier periods.
- A **loan payable** which is measured at the amount originally received and this amount is the same as the amount repayable on final maturity of the loan.
- **Accrued expenses** which will never be deductible for tax purposes.
- **Accrued income** which will never be taxable.

### 3.5 Temporary differences

- A taxable temporary difference arises where the carrying amount of an item exceeds its tax base.
- A deductible temporary difference arises where the tax base of an item exceeds its carrying amount.

Taxable and deductible differences and the circumstances that give rise to them are discussed in more detail in Sections 4 and 5 of this chapter.

### 3.6 Calculation of deferred tax assets and liabilities

The relevant tax rate is applied to a temporary difference in order to calculate the deferred tax asset or liability:

$$\begin{array}{lclclcl} \text{Taxable temporary} & \times & \text{Tax rate} & = & \text{Deferred tax liability} \\ \text{difference} & & & & \\ \\ \text{Deductible temporary} & \times & \text{Tax rate} & = & \text{Deferred tax asset} \\ \text{difference} & & & & \end{array}$$

The calculation of deferred tax assets and liabilities is discussed in more detail in Section 6 of this chapter.



#### QUESTION

#### Deferred tax assets and liabilities

- Calculate** the resulting temporary difference and deferred tax asset or liability for the assets in parts (a) to (d) of the question 'Tax base of an asset'.
- Calculate** the resulting temporary difference and deferred tax asset or liability for the liabilities in parts (a) and (b) of the question 'Tax base of a liability'.

The applicable tax rate in all cases is 28%.

#### ANSWER

##### Tax base of an asset

	Carrying amount	Tax base	Temporary difference	Deferred tax amount
(a)	Rs. 8,000	Rs. 7,000	Rs. 1,000 (taxable)	Rs. 280 (liability)
(b)	Rs. 1,000	Nil	Rs. 1,000 (taxable)	Rs. 280 (liability)
(c)	Rs. 3,000	Nil	Rs. 3,000 (taxable)	Rs. 840 (liability)
(d)	Rs. 2,200,00	Rs. 3,000,000	Rs. 800,000 (deductible)	Rs. 224,000 (asset)

##### Tax base of a liability

	Carrying amount	Tax base	Temporary difference	Deferred tax amount
(a)	Rs. (1,000)	Nil	Rs. 1,000 (deductible)	Rs. 280 (asset)
(b)	Rs. (10,000)	Nil	Rs. 10,000 (deductible)	Rs. 2,800(asset)

### 3.7 Presentation of deferred tax

Deferred tax assets and liabilities are generally netted off against each other and presented as a single amount in the statement of financial position.

Any change in the carrying amount from year to year is recognised in profit or loss, other comprehensive income or equity, depending on where the underlying transaction or event is recognised. The recognition and presentation of deferred tax is discussed in more detail in Sections 6 and 7 of this chapter.

## 4 Taxable temporary differences



**A taxable temporary difference** results in increased amounts of tax in the future and so a deferred tax liability.

Taxable temporary differences arise where the carrying amount of an asset or liability exceeds its tax base. These give rise to a deferred tax liability.

### 4.1 Understanding taxable temporary differences

It is useful to understand the reasoning behind the recognition of deferred tax liabilities on taxable temporary differences.

- (a) When an **asset is recognised**, it is expected that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods.
- (b) If the carrying amount of the asset is **greater than** its tax base, then taxable economic benefits will also be greater than the amount that will be allowed as a deduction for tax purposes.
- (c) The difference is therefore a **taxable temporary difference** and the obligation to pay the resulting income taxes in future periods is a **deferred tax liability**.
- (d) As the entity recovers the carrying amount of the asset, the taxable temporary difference will **reverse** and the entity will have taxable profit.
- (e) It is then probable that economic benefits will flow from the entity in the form of **tax payments**, and so the recognition of deferred tax liabilities is required by LKAS 12.

The following example will help you to understand this.





#### 4.1.1 Example: taxable temporary difference

A company purchased a machine costing Rs. 1,500 on 1 January 20X8. The asset has no residual value and is depreciated over five years. Tax depreciation allowances of 33.33% are available per annum on cost. The current tax rate is 28%.

- The carrying amount of the asset at 31 December is Rs. 1,200 ( $1,500 \times 4/5$  years).
- The tax base of the asset is Rs. 1,000 ( $1,500 - (1,500 \times 33.33\%)$ ).
- Therefore, there is a taxable temporary difference of Rs. 200 and a resulting deferred tax liability of Rs. 56 ( $200 \times 28\%$ ).

The financial statements would indicate that a depreciation expense of Rs. 1,200 will be recognised as the machine continues to be used. If this were tax allowable, future years' tax charges would be reduced by Rs. 336 ( $1,200 \times 28\%$ ).

However, tax relief is available on tax depreciation allowances, not accounting depreciation allowances. Future tax depreciation allowances will total Rs. 1,000 (the current tax base). Therefore, future years' tax charges will be reduced by only Rs. 280.

By creating a deferred tax liability of Rs. 56 at 31 December 20X8, we are indicating that Rs. 56 more tax will be payable in the future than might be expected based on the current carrying amount of the machine.

## 4.2 Examples of taxable temporary differences

The following are examples provided by LKAS 12 of circumstances that give rise to taxable temporary differences. They will all result in a higher tax charge in one or more future periods.

### 4.2.1 Items carried at historical cost

- (a) **Interest revenue** received in arrears and included in accounting profit when receivable but included in taxable profit on a cash basis.

Carrying amount	Interest receivable
Tax base	Nil

- (b) **Sale of goods revenue** is included in accounting profit when the goods are delivered, but only included in taxable profit when cash is received.

Carrying amount	Trade receivable
Tax base	Nil

- (c) **Depreciation** of an asset is accelerated for tax purposes, ie tax depreciation is given at a faster rate than accounting depreciation such that the carrying amount of an asset exceeds its tax base. This may be referred to as 'accelerated capital allowances'.

Carrying amount	Cost – depreciation
Tax base	Cost – tax depreciation

- (d) **Development costs** which have been capitalised will be amortised in profit or loss, but they were deducted in full from taxable profit in the period in which they were incurred.

Carrying amount	Cost – amortisation
Tax base	Nil

- (e) **Prepaid expenses** have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

Carrying amount	Prepayment
Tax base	Nil

- (f) A borrower records a **loan** at proceeds received (amount due at maturity) less transaction costs. The carrying amount of the loan is subsequently increased by amortisation of the transaction costs against accounting profit. The transaction costs were, however, deducted for tax purposes in the period when the loan was first recognised.

Carrying amount	Amortised cost
Tax base	Loan proceeds



## QUESTION

## Taxable temporary differences

Perera Chemicals Ltd is involved in the development of new chemical processes. At the start of October 20X6, it capitalised development costs of Rs. 160,000 and started to amortise them over 10 years in accordance with LKAS 38. These costs were relieved in full for tax purposes in the year ended 31 March 20X7.

The company also acquired a van on 1 April 20X6 for use in the business, costing Rs. 60,000. It is being depreciated over six years and attracts tax allowances of 20% on cost.

### Required

**Calculate** the temporary difference that arises on these assets at 31 March 20X7.

## ANSWER

### Development costs

- The development costs have a carrying amount of Rs. 152,000 ( $160,000 \times 114/120$  months).
- The tax base of the development costs is nil.
- A taxable temporary difference of Rs. 152,000 therefore arises.

### Van

- The van has a carrying amount of Rs. 50,000 ( $60,000 \times 5/6$ ).
- The tax base of the van is Rs. 48,000 ( $60,000 \times 80\%$ ).
- A taxable temporary difference of Rs. 2,000 therefore arises.

## 4.2.2 Items carried at fair value

- (a) **Current investments** or financial instruments are carried at fair value. This exceeds cost, but no equivalent adjustment is made for tax purposes.

Carrying amount	Fair value
Tax base	Cost

- (b) Property, plant and equipment can be **revalued** by an entity (under LKAS 16), but no equivalent adjustment is made for tax purposes. This also applies to long-term investments.

Carrying amount	Revalued amount
Tax base	Original cost – tax depreciation

In these cases, the deferred tax provision recognises that additional profit will be realised on the use or eventual disposal of these assets, leading to a higher tax charge.



## QUESTION

## Revaluation

Moratuwa Supplies (Pvt) Ltd revalued a factory to Rs. 32,000,000 on 31 December 20X8. The property had cost Rs. 24,000,000 four years previously, and was being depreciated over 50 years on a straight line basis. Capital allowances were provided on the property at 6.67% of cost. The applicable tax rate is 28%.

### Required

**Calculate** the deferred tax that arises on the revaluation, assuming that the revaluation gain does not form part of taxable income.

## ANSWER

- The carrying amount of the factory prior to revaluation was  $\text{Rs. } 24\text{m} \times 46/50 = \text{Rs. } 22.08\text{m}$ .
- The revalued amount is Rs. 32m.
- The revaluation gain of Rs. 9.92m is a taxable temporary difference.
- Therefore, a deferred tax liability of  $\text{Rs. } 9.92\text{m} \times 28\% = \text{Rs. } 2,777,600$  is recorded.

Note that deferred tax is only calculated on the revaluation gain – presumably a deferred tax liability already exists in the statement of financial position in respect of the difference between carrying amount based on historic cost of Rs. 22.08m and tax base of Rs. 17,596,800m ( $\text{Rs. } 24\text{m} - (4 \text{ years} \times 24\text{m} \times 6.67\%)$ )

## 4.3 Timing differences

LKAS 12 refers to some of the temporary differences listed above as **timing differences**. These are temporary differences where income or expense is included in accounting profit in one period but in taxable profit in a different period. Examples of timing differences which result in taxable temporary differences are:

- Interest revenue which is included in accounting profit when **receivable** but included in taxable profit when **received**.
- Tax depreciation allowances which are given at a faster rate than accounting depreciation ('accelerated capital allowances').
- Development costs which are capitalised and amortised for accounting purposes but are tax allowable in the period in which they are incurred.

## 4.4 Taxable temporary differences that do not result in deferred tax liabilities

LKAS 12 provides two circumstances where a taxable temporary difference does not give rise to a deferred tax liability:

- (a) The deferred tax liability arises from the initial recognition of goodwill.
- (b) The deferred tax liability arises from the initial recognition of an asset or liability in a transaction that:
  - (i) Is not a business combination
  - (ii) At the time of the transaction, affects neither accounting profit nor taxable profit



### 4.4.1 Example: initial recognition of an asset

The Liyanage Bus Company purchases an item of property, plant and equipment for Rs. 200,000. No tax deduction is available for this asset either through its use or on its eventual disposal.

There is therefore a taxable temporary difference of Rs. 200,000 on initial recognition of the asset. The asset was not purchased in a business combination, and therefore the resulting deferred tax liability would not be recognised.

## 5 Deductible temporary differences



**A deductible temporary difference** results in decreased amounts of tax in the future and so a deferred tax asset.

Deductible temporary differences arise where the **carrying amount of an asset or liability is less than its tax base**. These give rise to a deferred tax asset.

### 5.1 Understanding deductible temporary differences

It is useful to understand the reasoning behind the recognition of deferred tax assets on deductible temporary differences.

- (a) When a **liability is recognised**, it is assumed that its carrying amount will be settled in the form of outflows of economic benefits from the entity in future periods.
- (b) When these resources flow from the entity, part or all may be deductible in determining taxable profits of a **period later** than that in which the liability is recognised.

- (c) A **temporary tax difference** then exists between the carrying amount of the liability and its tax base.
- (d) A **deferred tax asset** therefore arises, representing the income taxes that will be recoverable in future periods when that part of the liability is allowed as a deduction from taxable profit.
- (e) Similarly, when the carrying amount of an asset is **less than its tax base**, the difference gives rise to a deferred tax asset in respect of the income taxes that will be recoverable in future periods.

The following example will help you to understand this.



#### 5.1.1 Example: deductible temporary difference

Pargatha (Pvt) Ltd recognises a liability of Rs. 10,000 for accrued product warranty costs on 31 December 20X7. These product warranty costs will not be deductible for tax purposes until the entity pays claims. The tax rate is 28%.

- The carrying amount of the liability at 31 December is Rs. 10,000.
- The tax base of the liability is nil.
- Therefore, there is a deductible temporary difference of Rs. 10,000 and a resulting deferred tax asset of Rs. 280 ( $10,000 \times 28\%$ ).

The financial statements include an expense of Rs. 10,000 on making the provision, and this reduces the accounting profit for the year.

It does not, however, reduce the taxable profit. This will happen in the future when warranty claims are settled. In future years, total tax charges will therefore reduce by Rs. 280 ( $10,000 \times 28\%$ ).

By creating a deferred tax asset of Rs. 280 at 31 December 20X7, we are indicating that Rs. 280 less tax will be payable in the future than might be expected based on the current carrying amount of the liability.

## 5.2 Examples of deductible temporary differences

The following are examples provided by LKAS 12 of circumstances that give rise to deductible temporary differences. They will all result in a lower tax charge in one or more future periods.

- (a) **Pension costs** are deducted from accounting profit, as service is provided by the employee. They are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. (This may also apply to similar expenses.)

<b>Carrying amount</b>	Carrying amount of pension asset/liability
<b>Tax base</b>	Carrying amount less the amount that will be tax deductible in the future

- (b) **Accumulated depreciation** of an asset in the financial statements is greater than the accumulated depreciation allowed for tax purposes up to the end of the reporting period.

<b>Carrying amount</b>	Cost – depreciation
<b>Tax base</b>	Cost – tax depreciation

- (c) The **cost of inventories** sold before the end of the reporting period is deducted from accounting profit when goods/services are delivered, but is deducted from taxable profit when the cash is received.

<b>Carrying amount</b>	Nil
<b>Tax base</b>	Cost of inventories

- (d) The **net realisable value (NRV)** of inventory falls and the carrying amount is therefore **reduced**, but that reduction is ignored for tax purposes until the asset is sold.

<b>Carrying amount</b>	Net realisable value
<b>Tax base</b>	cost

- (e) An item of PPE is impaired, but that reduction is ignored for tax purposes until the asset is sold.

<b>Carrying amount</b>	Impaired amount
<b>Tax base</b>	Cost – tax depreciation

- (f) **Research costs** (or organisation/other start-up costs) are recognised as an expense for accounting purposes but are not deductible against taxable profits until a later period.

<b>Carrying amount</b>	Nil
<b>Tax base</b>	Research costs deductible in future

- (g) Income is **deferred** in the statement of financial position, but has already been included in taxable profit in current/prior periods.

Carrying amount	Carrying amount
Tax base	Nil



## QUESTION

## Revaluation

De Silva Hotel Group Ltd contributes on behalf of its employees to a defined contribution pension scheme. At the end of 20X4, an accrual for contributions in the year of Rs. 50,000 has been made. The tax authorities allow deductions for payments to defined contribution plans on a cash basis.

### Required

**Calculate** the taxable difference, if any, that arises on the pension contributions.

## ANSWER

- The carrying amount of the pension accrual is Rs. 50,000.
- As the payment of Rs. 50,000 to the pension scheme will be allowed as a deduction when the cash is paid, the tax base of the pension accrual is nil (the carrying amount Rs. 50,000 less amount deductible for tax purposes in the future of Rs. 50,000).
- A deductible temporary difference of Rs. 50,000 therefore exists at the end of 20X4.

## 5.3 Unused tax losses and unused tax credits

An entity may have unused tax losses or credits which it can offset against taxable profits at the end of a period.

In Sri Lanka, tax losses should be first used in the current year, and remaining amount can be carried forward for future years. Where they are carried forward, LKAS 12 states that a deferred tax asset may be recognised **to the extent that it is probable that future taxable profit will be available against which the unused tax losses/credits can be utilised.**



### 5.3.1 Example: tax losses

At 31 December 20X1, Corea Communications Ltd has unused tax losses of Rs. 750,000 and taxable temporary differences of Rs. 250,000 relating to the same taxation authority.



Corea Communications has been loss making for the last two years.

In the absence of convincing evidence that there will be sufficient taxable profits against which the deductible temporary differences can be realised, a deferred tax asset is only recognised to the extent of the taxable temporary differences.

Therefore, a deferred tax asset is recognised for Rs. 250,000 of the unused tax losses and a deferred tax liability is recognised for the Rs. 250,000 taxable temporary differences.

## 5.4 Deductible temporary differences that do not result in deferred tax assets

As with temporary taxable differences, there are also circumstances where the overall rule for recognition of a deferred tax asset is **not** allowed. This applies where the deferred tax asset arises from **initial recognition** of an asset or liability in a transaction which is not a business combination **and**, at the time of the transaction, affects neither accounting nor taxable profit/tax loss.

The example given by the standard is of a non-taxable government grant related to an asset, deducted in arriving at the carrying amount of the asset. For tax purposes, however, it is **not** deducted from the asset's depreciable amount (ie its tax base). The carrying amount of the asset is less than its tax base and this gives rise to a deductible temporary difference, however this is not recognised as a deferred tax asset.



### 5.4.1 Example: initial recognition of an asset

Company A purchases an item of property, plant and equipment for Rs. 100,000. Tax deductions of Rs. 150,000 will be available for that asset. There is therefore a deductible temporary difference of Rs. 50,000. As this temporary difference arose on the initial recognition of an asset, and it was not acquired as part of a business combination, no deferred tax should be recognised for this deductible temporary difference.

## 6 Deferred tax assets and liabilities



**A deferred tax liability** is measured as a taxable temporary difference  $\times$  tax rate; a deferred tax asset is measured as a deductible temporary difference  $\times$  tax rate.

LKAS 12 adopts the full provision method of providing for deferred tax, meaning that deferred tax is provided for on all temporary differences regardless of the plans of an entity.

## 6.1 Measurement

### 6.1.1 Tax rate

Deferred tax assets and liabilities should be measured at the tax rates that are expected to apply to the period when the asset is realised or liability is settled, based on tax rates that have been enacted or substantively enacted by the end of the reporting period.

In some countries, different tax rates apply to different levels of taxable income. In such cases, deferred tax assets and liabilities should be measured using the **average rates** that are expected to apply to the taxable profit (loss) of the periods in which the temporary differences are expected to reverse.



### 6.1.2 Example: tax rates

Negombo (Pvt) Ltd has an asset with a carrying amount of Rs. 80,000 and a tax base of Rs. 50,000. The current tax rate is 28% and the rate is being reduced to 25% in the next tax year. Negombo plans to dispose of the asset for its carrying amount and will do so after the tax rate falls.

The deferred tax on the temporary difference is therefore  $\text{Rs. } 30,000 \times 25\% = \text{Rs. } 7,500$ .

### 6.1.3 Manner of recovery

LKAS 12 requires that the tax rate applied to a temporary difference in order to measure a deferred tax asset or liability reflects the tax consequences of the expected manner of recovery of the carrying amount of the underlying asset or liability.

In some jurisdictions, the manner of recovery may affect:

- (a) The tax rate applicable
- (b) The tax base of the asset or liability



### 6.1.4 Example: manner of recovery

Dambulla Imports (Pvt) Ltd has an asset with a carrying amount of Rs. 100,000 and a tax base of Rs. 60,000. The company operates in a jurisdiction where, if the asset were sold, a tax rate of 25% would apply. A tax rate of 32% would apply to other income.

- If the entity sells the asset without further use, a deferred tax liability is recognised of  $\text{Rs. } (100,000 - 60,000) \times 25\% = \text{Rs. } 10,000$ .

- If the entity expects to recover the carrying amount of the asset through use, a deferred tax liability is recognised of Rs.  $(100,000 - 60,000) \times 32\% = \text{Rs. } 12,800$

### 6.1.5 Discounting

LKAS 12 does not permit a deferred tax asset or liability to be discounted to present value. This is because the reliable determination of a discounted amount requires detailed scheduling of the timing of reversal of each temporary difference, and this is impracticable.

## 6.2 Recognition of a deferred tax asset or liability

A deferred tax liability should be recognised in respect of all taxable temporary differences.

A deferred tax asset should be recognised for all deductible temporary differences to the extent that it is **probable that future taxable profit will be available** against which it can be utilised.

### 6.2.1 Future taxable profit

LKAS 12 states that there is assumed to be future taxable profit available when sufficient **taxable temporary differences** exist which relate to the same taxation authority and the same taxable entity. These should be expected to reverse as follows.

- (a) In the same period as the expected reversal of the deductible temporary difference
- (b) In periods into which a tax loss arising from the deferred tax asset can be carried back or forward

Only in these circumstances is the deferred tax asset **recognised**, in the period in which the deductible temporary differences arise.

### 6.2.2 Insufficient taxable temporary differences

What happens when there are **insufficient taxable temporary differences** (relating to the same taxation authority and the same taxable entity)?

It may still be possible to recognise the deferred tax asset, but only to the following extent.

- (a) **Taxable profits** are sufficient in the same period as the reversal of the deductible temporary difference (or in the periods into which a tax loss arising from the deferred tax asset can be carried forward or backward),

ignoring taxable amounts arising from deductible temporary differences arising in future periods.

- (b) **Tax planning opportunities** exist that will allow the entity to create taxable profit in the appropriate periods.

With reference to (b), **tax planning opportunities** are actions that an entity would take in order to create or increase taxable income in a particular period before the expiry of a tax loss or tax credit carry forward. For example, in some countries it may be possible to increase or create taxable profit by electing to have interest income taxed on either a received or receivable basis, or deferring the claim for certain deductions from taxable profit.

In any case, where tax planning opportunities **advance taxable profit** from a later period to an earlier period, the utilisation of a tax loss or a tax credit carry forward will still depend on the existence of future taxable profit from sources other than future originating temporary differences.

If an entity has a **history of recent losses**, then this is evidence that future taxable profit may not be available.

### 6.2.3 Reassessment of unrecognised deferred tax assets

For **all** unrecognised deferred tax assets, at each year end, an entity should **reassess the availability of future taxable profits** and whether part or all of any unrecognised deferred tax assets should now be recognised. This may be due to an improvement in trading conditions that is expected to continue.

## 6.3 Recognition of deferred tax charge

The movement in the overall deferred tax asset or liability from year to year is normally recognised as income or an expense and included in the net profit or loss for the period.

The exceptions to this rule are where the tax arises from the events below.

- (a) A transaction or event that is recognised (in the same or a different period) in **other comprehensive income** (eg a revaluation)
- (b) A transaction or event that is recognised (in the same or a different period) **directly in equity** (eg the correction of an error)

Where transactions or events are recognised in other comprehensive income or directly in equity, the related tax is recognised similarly.



## QUESTION

## Accelerated capital allowances

Colombo Wholesale Ltd buys equipment for Rs. 600,000 and depreciates it on a straight line basis over its expected useful life of five years. For tax purposes, the equipment is written off over three years. Tax losses may be carried back against taxable profit of the previous five years. In year 20X0, the entity's taxable profit was Rs. 250,000. The tax rate is 28%.

### Required

Assuming Rs. 100,000 profits after depreciation in years 20X1 to 20X5, **record** the current and deferred tax impact in years 20X1 to 20X5 of the acquisition of the equipment.

## ANSWER

Colombo Wholesale Ltd will recover the carrying amount of the equipment by using it to manufacture goods for resale. Therefore, the entity's current tax computation is as follows.

	Year				
	20X1	20X2	20X3	20X4	20X5
	Rs	Rs	Rs	Rs	Rs
Taxable income*	220,000	220,000	220,000	220,000	220,000
Depreciation for tax purposes	<u>200,000</u>	<u>200,000</u>	<u>200,000</u>	<u>00</u>	<u>0</u>
Taxable profit	<u>20,000</u>	<u>20,000</u>	<u>20,000</u>	<u>220,000</u>	<u>220,000</u>
Current tax expense at 28%	<u>5,600</u>	<u>5,600</u>	<u>5,600</u>	<u>61,600</u>	<u>61,600</u>

\* Ie Rs. 100,000 profit plus (Rs. 600,000 ÷ 5) depreciation add-back.

The temporary differences associated with the equipment and the resulting deferred tax asset and liability and deferred tax expense and income are as follows.

	Year				
	20X1	20X2	20X3	20X4	20X5
	Rs	Rs	Rs	Rs	Rs
Carrying amount	480,000	360,000	240,000	120,000	0
Tax base	<u>400,000</u>	<u>200,000</u>	<u>0</u>	<u>0</u>	<u>0</u>
Taxable temporary difference	<u>80,000</u>	<u>160,000</u>	<u>240,000</u>	<u>120,000</u>	<u>0</u>
Opening deferred tax liability	0	22,400	44,800	67,200	33,600
Deferred tax expense (income): bal fig	<u>22,400</u>	<u>22,400</u>	<u>22,400</u>	<u>(33,600)</u>	<u>(33,600)</u>
Closing deferred tax liability @ 28%	<u>22,400</u>	<u>44,800</u>	<u>67,200</u>	<u>33,600</u>	<u>0</u>

The entity recognises the deferred tax liability in years 20X1 to 20X4 because the reversal of the taxable temporary difference will create taxable income in subsequent years. The entity's statement of profit or loss is as follows.

	Year				
	20X1	20X2	20X3	20X4	20X5
	Rs	Rs	Rs	Rs	Rs
Profit before tax	100,000	100,000	100,000	100,000	100,000
Current tax expense (income)	5,600	5,600	5,600	61,600	61,600
Deferred tax expense (income)	<u>22,400</u>	<u>22,400</u>	<u>22,400</u>	<u>(33,600)</u>	<u>(33,600)</u>
Total tax expense (income)	<u>28,000</u>	<u>28,000</u>	<u>28,000</u>	<u>28,000</u>	<u>28,000</u>
Net profit for the year	<u>72,000</u>	<u>72,000</u>	<u>72,000</u>	<u>72,000</u>	<u>72,000</u>

## 7 Taxation in company accounts



In the **statement of financial position**, the liability for tax payable is the tax on the current year profits. In the **statement of profit or loss**, the tax on the current year profits is adjusted for transfers to or from the deferred tax balance and for prior year under- or overprovision.

### 7.1 Taxation in the statement of profit or loss

The tax on profit on ordinary activities is calculated by **aggregating**:

- (a) **Income tax** on taxable profits
- (b) **Transfers to or from deferred taxation**
- (c) Any **underprovision or overprovision** of income tax on profits of previous years



#### QUESTION

#### Accelerated capital allowances

In the accounting year to 31 December 20X3, Katana Distributors (Pvt) Ltd made an operating profit before taxation of Rs. 155,000.

Income tax on the operating profit has been estimated as Rs. 45,000. In the previous year (20X2), income tax on 20X2 profits had been estimated as Rs. 38,000, but it was subsequently agreed at Rs. 40,500.

A transfer to the credit of the deferred taxation account of Rs. 16,000 will be made in 20X3.

#### Required

- (a) **Calculate** the tax on profits for 20X3 for disclosure in the accounts.
- (b) **Calculate** the amount of tax payable.

**ANSWER**

(a)	Rs
Income tax on profits (liability in the statement of FP)	45,000
Deferred taxation	16,000
Underprovision of tax in previous year Rs. (40,500 – 38,000)	<u>2,500</u>
Tax on profits for 20X3 (profit or loss charge)	<u>63,500</u>
(b)	Rs
Tax payable on 20X3 profits (liability)	<u>45,000</u>

**7.2 Taxation in the statement of financial position**

It should already be apparent from the previous examples that the income tax charge in profit or loss will not be the same as income tax liabilities in the statement of financial position.

In the statement of financial position, there are several items that we might expect to find.

- (a) There will usually be a **liability for tax** assessed as due for the current year.
- (b) If no tax is payable (or very little), then there might be an **income tax recoverable asset** disclosed in current assets (income tax is normally recovered by offset against the tax liability for the year).
- (c) We may also find a liability or asset on the deferred taxation account.

**7.2.1 Presentation of tax assets and liabilities**

Tax assets and liabilities should be presented separately from other assets and liabilities in the statement of financial position. Deferred tax assets and liabilities should be distinguished from current assets and liabilities.

In addition, deferred tax assets/liabilities should **not** be classified as current assets/liabilities, where an entity makes such a distinction.

**7.2.2 Offsetting**

As we saw earlier, **current tax** assets and liabilities may be **offset** only if two things apply:

- (a) The entity has a legally enforceable right to set off the recognised amounts.
- (b) The entity intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

Similar criteria apply to the offset of deferred tax assets and liabilities.

### 7.3 Tax disclosures

The following must be disclosed in relation to income taxes.

- (a) The major components of tax expense in profit or loss including the current tax expense, adjustments in relation to the tax of previous periods and deferred tax expense/income amounts relating to the origination and reversal of temporary differences and changes in tax rates.
- (b) The aggregate current and deferred tax relating to items that are charged or credited directly to equity.
- (c) The amount of income tax relating to each component of other comprehensive income.
- (d) An explanation of the relationship between tax expense and accounting profit.
- (e) An explanation of changes in the applicable tax rates compared to the previous period.
- (f) The amount of any deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised.
- (g) In respect of each type of temporary difference:
  - (i) The amount of deferred tax assets and liabilities recognised in the statement of financial position
  - (ii) The amount of deferred tax income or expense recognised in profit or loss
- (h) The amount of a deferred tax asset and the nature of evidence supporting its recognition when:
  - (i) The utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences.
  - (ii) The entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.





## CHAPTER ROUNDUP

- ↳ **LKAS 12 *Income taxes*** deals with current tax and deferred tax.
- ↳ **Current tax** is the amount payable to the tax authorities in relation to the trading activities of the period.
- ↳ **Deferred tax** is an accounting measure used to match the future tax effects of transactions with their accounting impact.
- ↳ **A taxable temporary difference** results in increased amounts of tax in the future and so a deferred tax liability.
- ↳ **A deductible temporary difference** results in decreased amounts of tax in the future and so a deferred tax asset.
- ↳ **A deferred tax liability** is measured as a taxable temporary difference  $\times$  tax rate; a deferred tax asset is measured as a deductible temporary difference  $\times$  tax rate.
- ↳ In the **statement of financial position**, the liability for tax payable is the tax on the current year profits. In the **statement of profit or loss**, the tax on the current year profits is adjusted for transfers to or from the deferred tax balance and for prior year under- or over-provision.


**PROGRESS TEST**

- 1 What is the difference between 'current tax' and 'deferred tax'?
- 2 How should current tax be measured?
  - A The total liability, including deferred tax
  - B The amount expected to be paid to (or recovered from) the tax authorities
  - C The amount calculated on profit at current tax rates
  - D The amount calculated on profit at future tax rates
- 3 A taxable temporary difference gives rise to a deferred tax liability. True or false?
- 4 What tax rate should be applied to a temporary difference?
- 5 Current tax assets and liabilities cannot be offset. True or false?
- 6 A company purchased a factory on 1 June 20X3 for Rs. 2m. The factory is depreciated at a rate of 2% per annum and attracts tax depreciation allowances of 6.67% per annum on cost. During the year, there was a crash in commercial property values and at 31 May 20X4 the factory had a recoverable amount of Rs. 1.8m.

What temporary difference arises on the factory at 31 May 20X4?

- A Rs. 93,400 taxable temporary difference
  - B Rs. 93,400 deductible temporary difference
  - C Rs. 66,600 taxable temporary difference
  - D Rs. 66,600 deductible temporary difference
- 7 A company has an asset with a carrying amount of Rs. 200,000 and a tax base of Rs. 150,000. The current income tax rate is 28% and this rate is being reduced to 25% in the next tax year. The current capital gains tax rate is 18% and this will reduce to 15% in the next tax year. The company plans to sell the asset for its carrying amount and will do so after the tax rate falls.

What tax rate should be used to calculate the deferred tax amount?

- A 15%
  - B 18%
  - C 25%
  - D 28%

- 8** A company has taxable profits of Rs. 340,000 in the year ended 31 December 20X8. Corporate income tax of Rs. 67,000 was accrued at 31 December 20X7 in respect of the previous year, and this was settled in 20X8 at Rs. 64,300. The company also has net taxable temporary differences of Rs. 190,000 at 31 December 20X8. The deferred tax liability at 31 December 20X7 was Rs. 59,700. The applicable tax rate is 28%.

What is the total tax charge to profit or loss for the year ended 31 December 20X8?

- A Rs. 86,000
- B Rs. 99,000
- C Rs. 91,400
- D Rs. 104,400

## ANSWERS TO PROGRESS TEST

- 1 (a) Current tax is the amount actually payable to the tax authorities.  
(b) Deferred tax is used to match the tax effects of transactions with their accounting impact.
- 2 The answer is **B**. The amount expected to be paid to (or recovered from) the tax authorities
- 3 True – and a deductible temporary difference gives rise to a deferred tax asset.
- 4 The tax rate expected to apply when the underlying asset is realised or liability settled, based on tax laws enacted at the reporting date. It should also take into account the manner of recovery of the underlying item.
- 5 False. They can be offset only if the entity has a legally enforceable right to offset and it intends to offset.
- 6 The answer is **D**. The carrying amount of the factory is Rs. 1,800,000.  
The tax base of the factory is Rs. 1,866,600.  
Therefore, there is a deductible temporary difference of Rs. 66,600.
- 7 The answer is **A**. The applicable tax rate should be:
  - That which will apply when the carrying amount of the asset is recovered
  - That which is applicable to the manner of recovery
- 8 The answer is **A**. Tax on profits in the year is  $(340,000 \times 28\%) = \text{Rs. } 95,200$ .  
This is reduced by last year's overprovision of Rs. 2,700.  
It is further reduced by the reduction in the deferred tax liability from Rs. 59,700 to Rs. 53,200  $(190,000 \times 28\%)$ .

	Rs
Tax on profits of the year	95,200
Overprovision	(2,700)
Reduction in deferred tax liability	<u>(6,500)</u>
Tax charge	86,000

# Financial Instruments

## INTRODUCTION

LKAS 32 *Financial instruments: presentation* and LKAS 39 *Financial instruments: recognition and measurement* deal with identifying financial assets and liabilities and prescribing their measurement. SLFRS 7 *Financial instruments: disclosures* provides the disclosure requirements related to these standards.

LKAS 39 is in the process of being replaced by SLFRS 9 *Financial instruments*; although LKAS 39 remains applicable for the foreseeable future SLFRS 9 can be adopted early on a voluntary basis. The requirements of both standards are therefore covered in this chapter.

Knowledge Component			
<b>2</b>	<b>Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)</b>		
<b>2.2</b>	<b>Level B</b>	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.
<b>2.3</b>	<b>Level C</b>	2.3.1	Explain the concepts/principles of Sri Lanka Accounting Standards.
		2.3.2	Apply the concepts/principles of the standards to resolve a simple/straightforward matter.
		2.3.3	List the disclosures to be made in the financial statements.

<b>CHAPTER CONTENTS</b>	<b>LEARNING OUTCOME</b>
1 Introduction	2.2, 2.3
2 Financial assets, liabilities and equity	2.2, 2.3
3 Recognition and derecognition of financial instruments	2.2, 2.3
4 Financial assets	2.2, 2.3
5 Financial liabilities	2.2, 2.3
6 Derivatives	2.2, 2.3
7 Disclosures	2.2, 2.3
8 Related Interpretation	2.2, 2.3

## **LKAS 39 Learning objectives**

- Explain financial assets, financial liabilities and equity instruments.
- Discuss recognition and derecognition requirements of financial assets and financial liabilities.
- Discuss the classification of financial assets and financial liabilities, and their measurement.
- Discuss the treatment of gain and losses arising on financial assets and financial liabilities.
- Discuss fair value measurement considerations of financial assets.
- Discuss the treatment of impairment of financial assets.
- Describe derivative financial instruments and simple embedded derivatives.

## **SLFRS 7 Learning objectives**

- Explain the significance of financial instruments for financial position and performance.
- Recognise the categories of items that shall be disclosed in the statement of financial position or in the notes.
- Recognise the categories of items that shall be disclosed in the statement of profit or loss and other comprehensive income or in the notes.
- Outline the qualitative and quantitative disclosures of nature and extent of risk arising from financial instruments.

## 1 Introduction



**Accounting for financial instruments is a complex area, with requirements coming from a number of accounting standards.**

You have already met some of the accounting standards that deal with financial instruments at the KE1 level. They are:

LKAS 32 *Financial instruments: presentation*

LKAS 39 *Financial instruments: recognition and measurement*

SLFRS 9 *Financial instruments*

LKAS 32 deals with identifying whether a financial instrument is a financial asset, a financial liability or equity.

LKAS 39 deals with how a financial asset or financial liability should be measured. This standard will, in the future, be phased out and companies will instead be required to apply SLFRS 9, which deals with the same issues. Currently, it is the case that LKAS 39 remains in force for companies that do not choose to adopt SLFRS 9 on a voluntary basis. You may see both of these standards in practice.

In this chapter, we shall revise your existing knowledge of these three standards and expand on the detail seen at KE1 level. In addition, we meet a fourth standard related to financial instruments: SLFRS 7 *Financial instruments: disclosure*.

SLFRS 7 contains all of the disclosure requirements in relation to financial instruments.

## 2 Financial assets, liabilities and equity



**A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity in another entity. LKAS 32 establishes the principles for establishing whether an instrument is a financial liability or equity.**

### 2.1 Definitions

LKAS 32 and LKAS 39 provide the following definitions.



**Financial instrument.** Any contract that gives rise to both a financial asset of one entity, and a financial liability or equity instrument of another entity.

**Financial asset.** Any asset that is:

- (a) Cash
- (b) An equity instrument of another entity
- (c) A contractual right to receive cash or another financial asset from another entity; or to exchange financial instruments with another entity under conditions that are potentially favourable to the entity

**Financial liability.** Any liability that is a contractual obligation:

- (a) To deliver cash or another financial asset to another entity, or
- (b) To exchange financial instruments with another entity under conditions that are potentially unfavourable

**Equity instrument.** Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

We should clarify some points arising from these definitions. Firstly, one or two terms above should be themselves defined.

- (a) A 'contract' need not be in writing, but it must comprise an agreement that has 'clear economic consequences' and which the parties to it cannot avoid, usually because the agreement is enforceable in law.
- (b) An 'entity' here could be an individual, partnership, incorporated body or government agency.

The definitions of financial assets and financial liabilities may seem rather circular, referring as they do to the terms financial asset and financial instrument. The point is that there may be a chain of contractual rights and obligations, but it will lead ultimately to the receipt or payment of cash **or** the acquisition or issue of an equity instrument.

Some financial instruments are extremely complex; typical instruments that you may see at KB1 level include:

Financial assets	Financial liabilities
Trade receivables	Trade payables
Equity investment	Redeemable debt
Debt investment	



LKAS 32 makes it clear that the following items are **not** financial instruments.

- (a) **Physical assets**, eg inventories and property, plant and equipment.
- (b) **Prepaid expenses**, deferred income and most warranty obligations
- (c) Liabilities or assets that are **not contractual** in nature (since a financial instrument requires the existence of a contract)

## 2.2 Liabilities and equity

LKAS 32 requires that financial instruments issued by an entity are presented as financial liabilities or equity according to their substance, not merely their legal form.

The classification of a financial instrument as a liability or as equity depends on the following.

- The substance of the contractual arrangement on initial recognition
- The definitions of a financial liability and an equity instrument

The critical feature of a liability is an obligation to transfer economic benefit. Therefore, a financial instrument is a financial liability if there is a contractual liability, but in substance it is in fact a liability. Other instruments may combine features of both equity instruments and financial liabilities.

### 2.2.1 Redeemable preference shares

Many companies issue preference shares that must be redeemed by the issuer for a fixed amount at a fixed future date. Alternatively, the holder may have the right to require the issuer to redeem the shares at or after a certain date for a fixed amount. In such cases, the issuer has an obligation. Therefore, the instrument is a financial liability and should be classified as such.

The distinction between redeemable and non-redeemable preference shares is important. Most preference shares are redeemable and are therefore classified as a financial liability.

### 2.2.2 Compound financial instruments

Some financial instruments contain both a liability and an equity element. In such cases, LKAS 32 requires the component parts of the instrument to be classified separately, according to the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument.

One of the most common types of compound instrument is convertible debt. This creates a primary financial liability of the issuer and grants an option to the holder

of the instrument to convert it into an equity instrument (usually ordinary shares) of the issuer. This is the economic equivalent of the issue of conventional debt plus a warrant to acquire shares in the future.

Although in theory there are several possible ways of calculating the split, LKAS 32 requires the following method:

- (a) Measure the liability component
- (b) Deduct this from the instrument as a whole to leave a residual value for the equity component

The reasoning behind this approach is that an entity's equity is its residual interest in its assets amount after deducting all its liabilities.

The sum of the carrying amounts assigned to liability and equity will always be equal to the carrying amount that would be ascribed to the instrument as a whole.



### 2.2.3 Example: compound financial instruments

Fernando Industries PLC issues 2,000 convertible bonds at the start of 20X2. The bonds have a three-year term, and are issued at par with a face value of Rs. 100,000 per bond, giving total proceeds of Rs. 200,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible at any time up to maturity into 250 ordinary shares.

When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9%.

#### Required

**Calculate** the value of the equity component in the bond.

#### Solution

The liability component is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9%, the market interest rate for similar bonds having no conversion rights, as shown.

	Rs
Present value of the principal: Rs. 200m payable at the end of three years	
Rs. 200m $\times$ 0.772183*	154,436,600
Present value of the interest: Rs. 12m payable annually in arrears for three years	
Rs. 12m $\times$ 2.5313*	<u>30,375,600</u>
Total liability component	184,812,200
Equity component (balancing figure)	<u>15,187,800</u>
Proceeds of the bond issue	<u>200,000,000</u>

\* These figures can be obtained from discount and annuity tables or simply calculated arithmetically as follows.

	Rs
<b>Principal</b>	
Rs. 200m discounted at 9% over three years:	
200,000,000 $\times$ 1/1.09 <sup>3</sup>	154,436,600
<b>Interest</b>	
Year 1      12m/1.09	11,009,200
Year 2      12m/1.09 <sup>2</sup>	10,100,200
Year 3      12m/1.09 <sup>3</sup>	<u>9,266,200</u>
	<u>30,375,600</u>
Value of liability component	184,812,200
Equity component (balancing figure)	<u>15,187,800</u>
Proceeds of bond issue	<u>200,000,000</u>

The split between the liability and equity components remains the same throughout the term of the instrument, even if there are changes in the likelihood of the option being exercised. This is because it is not always possible to predict how a holder will behave. The issuer continues to have an obligation to make future payments until conversion, maturity of the instrument or some other relevant transaction takes place.



## QUESTION

## Convertible debt

A company issues Rs. 100m of 4% convertible loan notes at par on 1 January 20X9. The loan notes are redeemable for cash or convertible into equity shares on the basis of 20 shares per Rs. 500 of debt at the option of the loan note holder on 31 December 20Y1. Similar but non-convertible loan notes carry an interest rate of 9%.

The present value of Rs. 1 receivable at the end of the year based on discount rates of 4% and 9% can be taken as:

	4%	9%
	Rs	Rs
End of year 1	0.96	0.92
2	0.93	0.84
3	<u>0.89</u>	<u>0.77</u>
Cumulative	<u>2.78</u>	<u>2.53</u>

### Required

**Demonstrate** how these loan notes should be accounted for in the financial statements at 31 December 20X9.

### ANSWER

	Rs'000
<i>Statement of profit or loss</i>	
Finance costs (W2)	7,841
<i>Statement of financial position</i>	
Equity – option to convert (W1)	12,880
<i>Non-current liabilities</i>	
4% convertible loan notes (W2)	90,961
<i>Workings</i>	
1 <i>Equity and liability elements</i>	
	Rs'000
3 years interest ( $100,000 \times 4\% \times 2.53$ )	10,120
Redemption ( $100,000 \times 0.77$ )	<u>77,000</u>
Liability element	87,120
Equity element (balancing figure)	<u>12,880</u>
Proceeds of loan notes	<u>100,000</u>
2 <i>Loan note balance</i>	
	Rs'000
Liability element (W1)	87,120
Interest for the year at 9%	7,841
Less interest paid ( $100,000 \times 4\%$ )	<u>(4,000)</u>
Carrying value at 31 December 2009	<u>90,961</u>

## 2.3 Interest, dividends, losses and gains

As well as dealing with the presentation of financial instruments in the statement of financial position, LKAS 32 considers how financial instruments affect the

statement of profit or loss and other comprehensive income (and changes in equity). The treatment varies according to whether interest, dividends, losses or gains relate to a financial liability or an equity instrument.

- (a) Interest, dividends, losses and gains relating to a financial instrument classified as a financial liability are recognised as income or expense in profit or loss.
- (b) Dividends to equity shareholders are charged directly to equity by the issuer. These will appear in the statement of changes in equity.
- (c) Transaction costs of an equity transaction are accounted for as a deduction from equity.

### 3 Recognition and derecognition of financial instruments



**LKAS 39 *Financial instruments: recognition and measurement* provides guidance on when to recognise and when to derecognise a financial instrument.**

LKAS 39 *Financial instruments: recognition and measurement* provides recognition and derecognition criteria for both financial assets and financial liabilities. Recognition is usually more straightforward than derecognition and this is reflected in the level of guidance provided for both issues.

#### 3.1 Recognition

A financial asset or financial liability is recognised in the statement of financial position **when the reporting entity becomes a party to the contractual provisions of the instrument.**

Notice that this is different from the recognition criteria in the Conceptual Framework and in most other standards. Items are normally recognised when there is a probable inflow or outflow of resources and the item has a cost or value that can be measured reliably.

#### 3.2 Derecognition

Derecognition is the removal of a previously recognised financial instrument from an entity's statement of financial position.

### 3.2.1 Financial assets

An entity should derecognise a financial asset when:

- (a) The contractual rights to the cash flows from the financial asset expire, or
- (b) It transfers substantially all the risks and rewards of ownership of the financial asset to another party

For example, a trade receivable is derecognised when payment is collected. In this case, the rights to the cash flow associated with the asset expire (because the cash has been collected) and there is no further exposure to risks and rewards for the entity collecting the cash.

Some more complex transactions may not be so clear-cut, however these are not examinable at KB1 level.

### 3.2.2 Financial liabilities

An entity should derecognise a financial liability when it is extinguished – ie when the obligation specified in the contract is discharged or cancelled or expires.

### 3.2.3 Partial derecognition

It is possible for only part of a financial asset or liability to be derecognised. This is allowed if the part comprises:

- (a) Only specifically identified cash flows; or
- (b) Only a fully proportionate (pro-rata) share of the total cash flows.

For example, if an entity holds a bond it has the right to two separate sets of cash inflows: those relating to the principal and those relating to the interest. It could sell the right to receive the interest to another party while retaining the right to receive the principal.

### 3.2.4 Gain or loss on derecognition

On derecognition, the amount to be included in net profit or loss for the period is the difference between the carrying amount of the financial instrument derecognised and the proceeds paid (for a liability) or received (for an asset).

Any accumulated gains or losses that have been recognised in other comprehensive income in respect of available-for-sale financial assets (see Section 4) are also reclassified to profit or loss on derecognition of the asset.

Where only part of a financial asset is derecognised, the carrying amount of the asset should be allocated between the part retained and the part transferred

based on their relative fair values on the date of transfer. A gain or loss should be recognised based on the proceeds for the portion transferred.



## QUESTION

## Derecognition

Pacific Plants (Pvt) Ltd purchased equity shares in a listed company for Rs. 30m on 20 February 20X6, classifying them as available-for-sale. At 31 December 20X6 the investment was remeasured to a fair value of Rs. 35m, with an Rs. 5m gain recognised in other comprehensive income. Pacific Plants sold half of these shares in August 20X7 for Rs. 20m.

### Required

**Prepare** extracts from the statement of profit or loss and other comprehensive income for the year ended 31 December 20X7 in respect of the disposal.

## ANSWER

### Statement of profit or loss and other comprehensive income

	Rs'000
Gain on disposal of available-for-sale financial asset	5,000
<i>Other comprehensive income</i>	
Available-for-sale financial asset – reclassified to profit or loss	(2,500)

### Working

	Rs'000
Proceeds	20,000
Carrying amount ( $1/2 \times \text{Rs. } 35\text{m}$ )	<u>(17,500)</u>
Gain on derecognition	2,500
Reclassified from OCI ( $1/2 \times 5\text{m}$ )	<u>2,500</u>
Gain reported in profit or loss	<u>5,000</u>

## 3.3 SLFRS 9 *Financial instruments*

The recognition and derecognition criteria of SLFRS 9 are essentially the same as those of LKAS 39:

- (a) A financial asset or financial liability is recognised in the statement of financial position when the reporting entity becomes a party to the contractual provisions of the instrument.
- (b) It is derecognised when the entity ceases to be a party to the financial instrument's contractual provisions.

## 4 Financial assets



**There are four categories of financial asset: fair value through profit or loss, held-to-maturity, available-for-sale and loans and receivables.**

### 4.1 Classification of financial assets

LKAS 39 requires that financial assets are classified as one of the following types upon initial recognition.

- (1) **Financial assets at fair value through profit or loss (FVTPL)** are financial assets that are:
  - (a) Held for trading, ie it is:
    - Acquired principally for the purpose of sale in the short term
    - Part of a portfolio of financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit taking, or
    - A derivative (see Section 6)
  - (b) Designated as such – this is only allowed where:
    - It eliminates or significantly reduces an accounting mismatch
    - A group of assets is managed and its performance evaluated on a fair value basis
- (2) **Held-to-maturity (HTM) investments** are financial assets with fixed or determinable payments and fixed maturity that:
  - A company has the intention and ability to hold to maturity
  - Do not meet the definition of loans and receivables
  - Are not designated as fair value through profit or loss or available-for-sale
- (3) **Loans and receivables** are financial assets with fixed or determinable payments that are not quoted in an active market, are not held for trading and are not designated as either fair value through profit or loss or available-for-sale.
- (4) **Available-for-sale (AFS) financial assets** are non-derivative financial assets designated as available-for-sale or not classified under any of the other three headings.



### 4.1.1 Reclassification

In limited circumstances, non-derivative financial assets may be reclassified out of the fair value through profit or loss and available-for-sale categories into another category.

Other financial assets may be reclassified if circumstances change; in particular, held-to-maturity assets are reclassified if the intention or ability to hold to maturity no longer exists.

### 4.1.2 Tainting rules

The held-to-maturity classification of financial assets becomes 'tainted' where a financial asset classified as held-to-maturity is sold or reclassified before the maturity date.

As a result:

- All remaining held-to-maturity investments must be reclassified to available-for-sale and measured at fair value
- The held-to-maturity classification becomes unavailable for the two following accounting periods

## 4.2 Initial measurement of financial assets

A financial asset is initially measured at its fair value. Any transaction costs incurred in acquiring a financial asset are:

- Recognised as an expense when incurred in the case of financial assets measured at fair value through profit or loss
- Added to the fair value of other categories of financial asset to give initial measurement

## 4.3 Subsequent measurement of financial assets

The following table details the subsequent measurement of financial assets.

Classification	Measured at	Gains and losses recognised in
FVTPL	Fair value	Profit or loss
HTM	Amortised cost	Profit or loss
Loans and receivables	Amortised cost	Profit or loss
AFS	Fair value	Other comprehensive income

### 4.3.1 Fair value

Financial assets classified as fair value through profit or loss or available for sale are remeasured to fair value at each reporting date.

Fair value is defined in accordance with SLFRS 13 as follows.



**Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The requirements of SLFRS 13 should be applied in order to determine the fair value of a financial asset. These requirements were discussed in Section 3 of Chapter 2, and their specific application to financial assets in Section 3.7.1.



#### QUESTION

#### Financial assets measured at fair value

Lanka Linens (Pvt) Ltd acquires the following financial assets in 20X5.

- (1) Five million equity shares in a quoted company, to be held in the medium to long term. The cost of the investment was Rs. 360m, and transaction costs amounted to Rs. 2m. At 31 December 20X5 the closing bid price of one of the equity shares was Rs. 76.
- (2) Equity shares in another quoted company to be held as a short-term investment with the intention of realising a profit on sale. The cost of the investment was Rs. 120m, and transaction costs were Rs. 1.5m. The fair value of the investment at 31 December 20X5 was Rs. 115m.

#### Required

**Prepare** extracts of the financial statements of Lanka Linens for the year ended 31 December 20X5 in respect of the two financial asset investments.

#### ANSWER

- Investment 1 is classified as available-for-sale. Neither the held-to-maturity nor loans and receivables categories are available, since an equity investment does not result in fixed or determinable payments; FVTPL is inappropriate, since the investment is not held for trading.
- Investment 2 is held in the short term, and should be classified as fair value through profit or loss.

**Statement of profit or loss and other comprehensive income**

	Rs'000
Transaction costs (investment 2)	(1,500)
Loss on remeasurement to fair value (investment 2)	(5,000)
<i>Other comprehensive income</i>	
Gain on remeasurement of available-for-sale financial asset	18,000

**Statement of financial position**

	Rs'000
AFS financial asset	380,000
FVTPL financial asset	115,000
AFS reserve	18,000

*Working*

	<i>Inv't 1</i>	<i>Inv't 2</i>
	Rs'000	Rs'000
Cost	360	120
Transaction costs	<u>2</u>	<u>-</u>
Initial measurement	362	120
Gain/loss	<u>18</u>	<u>(5)</u>
Fair value at reporting date	380	115

**4.3.2 Amortised cost**

Financial assets classified as held-to-maturity (HTM) or loans and receivables are measured at amortised cost. This, together with other relevant terms, is defined in LKAS 39 as follows.



**Amortised cost** is the amount at which a financial asset or liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method or any difference between that initial amount and the maturity amount.

**The effective interest method** is a method of calculating the amortised cost of a financial instrument and of allocating the interest income or interest expense over the relevant period.

**The effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or liability.

Application of the effective interest method ensures that the interest receivable on a financial asset is accounted for together with any 'winding up' of the carrying amount of the asset from initial recognition to maturity value.

The following question has been adapted from a learning example in the KE1 file; see whether you can remember how to apply the method.



## QUESTION

## Financial assets at amortised cost

On 1 January 20X1, Purijjala Power PLC purchases a debt instrument for its fair value of Rs. 1,000m. The debt instrument is due to mature on 31 December 20X5 and Purijjala Power intends to hold it to maturity. The instrument has a principal amount of Rs. 1,250m and the instrument carries fixed interest at 4.72% that is paid annually. The effective rate of interest is 10%.

### Required

**Demonstrate** how Purijjala Power should account for the debt instrument over its five-year term.

## ANSWER

- The instrument is initially recognised at Rs. 1,000m.
- Interest is receivable annually of  $4.72\% \times \text{Rs. } 1,250\text{m} = \text{Rs. } 59\text{m}$ .
- On maturity, the principal of Rs. 1,250m is receivable; therefore the financial asset must be wound up by Rs. 250m by the maturity date.

This is achieved as follows.

Year	<i>Amortised cost at beginning of year</i> Rs million	<i>Profit or loss: Interest income for year (@10%)</i> Rs million	<i>Interest received during year (cash inflow)</i> Rs million	<i>Amortised cost at end of year</i> Rs million
20X1	1,000	100	(59)	1,041
20X2	1,041	104	(59)	1,086
20X3	1,086	109	(59)	1,136
20X4	1,136	113	(59)	1,190
20X5	1,190	119	(1,250 + 59)	–

Each year, the carrying amount of the financial asset is increased by the interest income for the year, and reduced by the interest actually received during the year.

In 20X1, the accounting entries in respect of the interest income are:

DEBIT	Cash	Rs. 59
DEBIT	Financial asset	Rs. 41
CREDIT	Interest income (SPL)	Rs. 100

## 4.4 Impairment of financial assets

At each reporting date, an entity should assess whether there is objective evidence that a financial asset or group of assets is impaired.

Indications that a financial asset is impaired include the following.

- Significant financial difficulty of the issuer
- A breach of contract such as a default in interest or principal payments
- The lender granting a concession, that it would not otherwise consider, to the borrower as a result of the borrower's financial difficulty
- It becomes probable that the borrower will enter bankruptcy
- An active market for the financial asset disappears due to financial difficulties
- Observable data that indicates there is a measurable decrease in the estimated future cash flows from a group of financial assets

### 4.4.1 Accounting for an impairment loss

The calculation of an impairment loss and its treatment depends on the classification of the impaired asset:

- (a) An impairment test is not necessary for financial assets classified as **fair value through profit or loss**, since they are measured at fair value with changes recognised in profit or loss in any case.
- (b) An impairment loss in respect of **loans and receivables** and **held-to-maturity** financial assets is measured as the difference between carrying amount and the present value of estimated future cash flows discounted using the original effective interest rate. The loss is recognised in profit or loss.
- (c) Where an **available-for-sale** financial asset is determined to be impaired, the loss that has been recognised in OCI is reclassified to profit or loss immediately. The impairment loss is calculated as the difference between acquisition cost and current fair value less any impairment losses already recognised. An impairment loss in respect of an available-for-sale financial asset can only be reversed where the asset is a debt instrument and an increase in fair value can be linked to an event occurring after the impairment.



#### 4.4.2 Example: impairment of financial assets

A company acquired an investment in equity shares in 20X1, and classified it as available-for-sale. The investment cost Rs. 150m and at 31 December 20X2 had a fair value (and carrying amount) of Rs. 125m. The total loss of Rs. 25m had been recognised in other comprehensive income in accordance with LKAS 39. The fair value of the investment fell further to Rs. 105m by 31 December 20X3, due to the likelihood of the issuing company entering bankruptcy.

#### Required

What amounts are recognised in the financial statements of the company in the year ended 31 December 20X3?

#### Solution

- The impairment arises in 20X3
- The loss is the acquisition cost of Rs. 150m less the 31 December 20X3 fair value of Rs. 105m, ie Rs. 45m
- The Rs. 25m loss already recognised in OCI is reclassified to profit or loss, and a further Rs. 20m loss is recognised in profit or loss, giving a total charge to profit or loss of Rs. 45m:

#### Statement of profit or loss and other comprehensive income

	Rs'000
Impairment loss	(45,000)
<i>Other comprehensive income</i>	
Available-for-sale financial asset – reclassified to profit or loss	25,000

### 4.5 SLFRS 9 *Financial instruments* – assets

#### 4.5.1 Classification

On recognition, SLFRS 9 requires that financial assets are classified as measured at:

- Amortised cost; or
- Fair value

A financial asset is classified as measured at amortised cost where:

- The objective of the business model, within which the asset is held, is to hold assets in order to collect contractual cash flows
- The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding

An application of these rules means that **equity investments** may not be classified as measured at amortised cost and must be measured at fair value. This is because contractual cash flows on specified dates are not a characteristic of equity instruments. Equally, **investments in convertible loan stock** may not be measured at amortised cost because the inclusion of the conversion option is not deemed to represent payments of principal and interest.

A **debt instrument** may be classified as measured at either amortised cost or fair value, depending on whether it meets the criteria above. Even where the criteria are met at initial recognition, a debt instrument may, in certain circumstances, be designated as measured at fair value through profit or loss.

SLFRS 9 requires that when an entity changes its business model for managing financial assets, it should reclassify all affected financial assets. This reclassification applies only to debt instruments, as equity instruments must be classified as measured at fair value.

#### 4.5.2 Initial measurement

The rules for the initial measurement of financial assets are unchanged from those of LKAS 39.

#### 4.5.3 Subsequent measurement

After initial recognition, SLFRS 9 requires an entity to measure financial assets at either amortised cost or fair value depending on their classification as discussed above:

Classification	Measured at	Gains and losses recognised in
Fair value	Fair value	Profit or loss
Amortised cost	Amortised cost	Profit or loss

SLFRS 9 refers to LKAS 39 as regards the calculation of amortised cost.

#### 4.5.4 Equity instruments

At initial recognition, equity instruments may be designated as measured at **fair value through other comprehensive income** (FVTOCI).

Equity instruments can be held at FVTOCI if:

- (a) They are not held for trading (ie the intention is to hold them for the long term to collect dividend income)

- (b) An irrevocable election is made at initial recognition to measure the investment at FVTOCI

If the investment is held at FVTOCI, all changes in fair value are recognised in other comprehensive income. Only dividend income will be recognised in profit or loss.

#### 4.5.5 Impairment of financial assets

The SLFRS 9 chapter on impairment of financial assets has not yet been issued.

## 5 Financial liabilities



There are two categories of financial liability: financial liabilities at fair value through profit or loss and other liabilities.

### 5.1 Classification of financial liabilities

Financial liabilities are classified at initial recognition as either:

- (1) **Financial liabilities at fair value through profit or loss (FVTPL)** if they are:
  - (a) Held for trading, ie:
    - Incurred principally for the purpose of repurchase in the short term
    - Part of a portfolio of financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit taking, or
    - A derivative (see Section 6)
  - (b) Designated as such. This is only allowed where:
    - It eliminates or significantly reduces an accounting mismatch
    - A group of liabilities is managed and its performance evaluated on a fair value basis
- (2) **Other liabilities**



## 5.2 Initial measurement of financial liabilities

A financial liability is initially measured at its fair value. Any transaction costs incurred are:

- Recognised as an expense when incurred in the case of financial liabilities measured at fair value through profit or loss
- Deducted from the fair value of other categories of financial asset to give initial measurement

## 5.3 Subsequent measurement of financial liabilities

The following table details the subsequent measurement of financial liabilities.

Classification	Measured at	Gains and losses recognised in
FVTPL	Fair value	Profit or loss
Other liabilities	Amortised cost	Profit or loss

### 5.3.1 Fair value

Financial liabilities classified as fair value through profit or loss are remeasured to fair value at each reporting date.

The requirements of SLFRS 13 should be applied in order to determine the fair value of a financial liability. These requirements were discussed in Section 3 of Chapter 2, and their specific application to financial liabilities in Section 3.7.2.

### 5.3.2 Amortised cost

As in the case of financial assets, the effective interest method winds up the liability initially recognised to its maturity date value. Therefore, finance costs may include:

- Interest paid out
- The winding up of the liability to redemption value

Try the following question, taken from the KE1 material, to ensure that you understand the measurement of financial liabilities at amortised cost.



#### QUESTION

#### Liabilities at amortised cost

A company issues 6% loan notes with a nominal value of Rs. 200,000. They are issued at a 5% discount and Rs. 1,700 of issue costs are incurred. The loan notes

will be repayable at a premium of 10% after four years. The effective interest rate is 10%.

### Required

**Record** what amounts will be shown in the statement of profit or loss and statement of financial position at the end of years 1 to 4.

### ANSWER

<i>Year</i>	<i>Statement of profit or loss – finance costs</i>	<i>Statement of financial position – 6% loan notes</i>
	<b>Rs</b>	<b>Rs</b>
1	18,830	195,130
2	19,513	202,643
3	20,264	210,907
4	21,093	-

### Working

		<b>Rs</b>
Year 1	Capital balance*	188,300
	Interest 10%	18,830
	Interest paid ( $200,000 \times 6\%$ )	<u>(12,000)</u>
Year 2 b/f		195,130
	Interest 10%	19,513
	Interest paid	<u>(12,000)</u>
Year 3 b/f		202,643
	Interest 10%	20,264
	Interest paid	<u>(12,000)</u>
Year 4 b/f		210,907
	Interest (balancing figure)**	21,093
	Interest paid	<u>(12,000)</u>
		220,000
	Capital repaid	<u>(220,000)</u>
		<u>-</u>

\*  $((200,000 \times 95\%) - 1,700)$

\*\* Note that the final interest amount is a balancing figure incorporating a Rs. 2 rounding difference.

## 5.4 SLFRS 9 *Financial instruments* – liabilities

### 5.4.1 Classification

The classification rules of SLFRS 9 are unchanged from those contained within LKAS 39.

### 5.4.2 Initial measurement

Again, the rules for the initial measurement of financial liabilities are unchanged from those of LKAS 39.

### 5.4.3 Subsequent measurement

After initial recognition, all financial liabilities should be measured at amortised cost, with the exception of financial liabilities at fair value through profit or loss. These should be measured at fair value, but where the fair value is not capable of reliable measurement, they should be measured at cost.

These rules are essentially the same as those within LKAS 39.

## 6 Derivatives



**A derivative is a financial instrument:**

- **Whose value changes in response to the change in price of an underlying security, commodity, currency, index or other financial instrument**
- **Where the initial net investment is zero or very small**
- **That is settled at a future date**

A derivative is a particular type of financial instrument whose value is related to an underlying item. Examples include:

- A forward contract to sell currency at a fixed exchange rate – the fair value of the forward fluctuates in response to movements in the exchange rate.
- An interest rate swap whereby a fixed interest rate is swapped for a variable rate – the fair value of the swap is related to the base rate (which influences the variable rate).
- An option to sell gold at a fixed price at a future date – the fair value of the option fluctuates in response to movements in the market price of gold and so whether the fixed price is more or less than the market price.

## 6.1 Accounting treatment

Derivatives may be a financial asset or a financial liability, depending on the movement in the underlying variable.

For example, if a company entered into a forward contract to sell coffee at a specified future date for Rs. 160 per pound, then:

- If the market price of coffee increases to Rs. 190 per pound, the contract is a financial liability, ie the company will be exchanging assets under unfavourable conditions.
- If the market price of coffee falls to Rs. 140 per pound, the contract is a financial asset, ie the company will be exchanging assets under favourable conditions.

Long-term derivatives may fluctuate between an asset and a liability position.

Regardless of whether a derivative is a financial asset or liability, it is classified as fair value through profit or loss and the usual accounting rules apply:

- (1) The derivative is initially measured at its fair value – usually nil.
- (2) At subsequent reporting dates, it is measured at fair value with changes recognised in profit or loss.



### 6.1.1 Example: accounting for a derivative

On 1 October 20X3, Plantation Products PLC commissioned a European company to design and build a large item of machinery for delivery at the end of March 20X4. Payment of €5m would be due on this date. In order to reduce exposure to fluctuations in the exchange rate, Plantation Products PLC also entered into a forward contract on 1 October 20X3 to buy €5m on 31 March 20X4 for a fixed amount of Rs. 875m. The contract has an initial fair value of zero.

At 31 December 20X3, the euro has appreciated and the value of €5m is Rs. 881m.

#### Required

**Demonstrate** how the forward contract is accounted for at 1 October 20X3 and 31 December 20X3.

#### Solution

At 1 October 20X3, there are no accounting entries in respect of the contract. It does meet the definition of a financial instrument; however, its initial measurement is zero.

At 31 December 20X3, the fair value of the forward contract is Rs. 881m – Rs. 875m = Rs. 6m.

By entering the contract, Plantation Products will pay Rs. 6m less for the machinery than it would otherwise have done. Therefore, this is a financial asset. The change in fair value is recognised by:

DEBIT	Forward contract (financial asset at FVTPL)	Rs. 6m
CREDIT	Profit or loss	Rs. 6m

## 6.2 Embedded derivatives

An embedded derivative is a derivative instrument that is embedded within a host contract that may or may not be a financial instrument. Host contracts may include a debt instrument, an equity instrument, insurance contracts, construction contracts, leases and sale contracts.

An example of a host contract with a derivative embedded in it is a lease agreement for commercial premises with rentals contingent on the level of revenue achieved.

### 6.2.1 Accounting treatment of embedded derivatives

An embedded derivative should be separated from its host contract and accounted for as a derivative provided that:

- (a) The economic characteristics and risks of the embedded derivative are not closely related to those of the host contract.
- (b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.
- (c) The hybrid instrument is not measured at fair value with changes recognised in profit or loss (in which case there is no benefit to separating the embedded derivative).

### 6.2.2 SLFRS 9 *Financial instruments*

SLFRS 9 simplifies the accounting treatment for embedded derivatives.

- (a) Where the host contract is a financial asset within the scope of SLFRS 9, the entire hybrid contract is accounted for as a financial asset in accordance with the SLFRS 9 measurement requirements.
- (b) Where the host contract is not a financial asset, the same provisions as those within LKAS 39 apply, ie the derivative must be separated out provided that the conditions listed above are met, and accounted for separately.

## 7 Disclosures



### **SLFRS 7 contains the disclosure requirements for financial instruments.**

In addition to disclosure about amounts reported in the financial statements in respect of financial instruments, SLFRS 7 *Financial instruments: disclosures* requires qualitative and quantitative disclosure about exposure to risks arising from financial instruments, and specifies minimum disclosures about credit risk, liquidity risk and market risk.

Users of financial instruments need information about an entity's exposures to risks and how those risks are managed, as this information can influence a user's assessment of the financial position and financial performance of an entity or of the amount, timing and uncertainty of its future cash flows.

Note that disclosures in relation to financial instruments measured at fair value are contained within SLFRS 13.

### **7.1 Objective of SLFRS 7**

The objective of the standard is to require entities to provide disclosures in their financial statements that allow users to evaluate:

- (a) The significance of financial instruments for an entity's position and performance
- (b) The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date and how the entity manages those risks

### **7.2 Classes of financial instruments and levels of disclosure**

When SLFRS 7 requires disclosures by class of financial instrument, an entity must group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. Sufficient information should be provided to permit reconciliation to the line items presented in the statement of financial position.

## 7.3 Significance of financial instruments for financial position and performance

### 7.3.1 Statement of financial position

The following must be disclosed in the notes to the financial statements.

- (a) **Carrying amount** of financial assets and liabilities by **HKAS 39 or HKFRS 9** category:
  - Financial assets measured at fair value through profit or loss, showing separately those designated as such and those classified as held for trading
  - Held-to-maturity investments
  - Loans and receivables
  - Available-for-sale financial assets
  - Financial liabilities measured at fair value through profit or loss, showing separately those designated as such and those classified as held for trading
  - Financial liabilities measured at amortised cost
- (b) Details of financial instruments designated as at fair value through profit or loss.
- (c) Reason for any reclassification between fair value and amortised cost (and *vice versa*) and amounts reclassified.
- (d) Details of any financial assets and liabilities that have been offset.
- (e) The carrying amount of financial assets the entity has pledged as collateral for liabilities or contingent liabilities and the associated terms and conditions.
- (f) When financial assets are impaired by credit losses and the entity records the impairment in a separate account (eg an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it must disclose a reconciliation of changes in that account during the period for each class of financial assets.
- (g) The existence of compound financial instruments with multiple embedded derivatives.
- (h) Defaults and breaches.

### 7.3.2 Statement of profit or loss and other comprehensive income

The entity must disclose the following **items of income, expense, gains or losses**, either on the face of the financial statements or in the notes:

- (a) Net gains/losses on:
  - Financial assets and liabilities measured at fair value through profit or loss, showing separately those designated as such and those classified as held for trading
  - Held-to-maturity investments
  - Loans and receivables
  - Available-for-sale financial assets
  - Financial liabilities measured at fair value through profit or loss, showing separately those designated as such and those classified as held for trading
- (b) Interest income/expense
- (c) Impairment losses by class of financial asset

### 7.4 Nature and extent of risks arising from financial instruments

In undertaking transactions in financial instruments, an entity may assume or transfer to another party one or more of **different types of financial risk** as defined below. The disclosures required by the standard show the extent to which an entity is exposed to these different types of risk, relating to both recognised and unrecognised financial instruments.

<b>Credit risk</b>	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
<b>Currency risk</b>	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
<b>Interest rate risk</b>	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
<b>Liquidity risk</b>	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.
<b>Loans payable</b>	Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.



<b>Market risk</b>	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.
<b>Other price risk</b>	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.
<b>Past due</b>	A financial asset is past due when a counterparty has failed to make a payment when contractually due.

#### 7.4.1 Qualitative disclosures

For each type of risk arising from financial instruments, an entity must disclose:

- (a) The exposures to risk and how they arise
- (b) Its objectives, policies and processes for managing the risk and the methods used to measure the risk
- (c) Any changes in (a) or (b) from the previous period

#### 7.4.2 Quantitative disclosures

For each type of risk, summary quantitative data about risk exposure at the reporting date must be disclosed. This should be based on the information provided internally to key management personnel. More information should be provided if this is unrepresentative of an entity's exposure to risk.

The following information about **credit risk** must be disclosed by class of financial instrument.

- (a) Maximum exposure to credit risk at the year end without taking account of collateral held or other credit enhancements. (This disclosure is not required where the carrying amount of financial instruments best represents the maximum exposure to credit risk.)
- (b) A description of collateral held as security and of other credit enhancements, and their financial effect, in respect of the maximum exposure to credit risk (whether as disclosed in (a) or represented by carrying amount).
- (c) Information about the credit quality of financial assets that are neither past due nor impaired.

- (d) An analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired.
- (e) An analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired.
- (f) Collateral and other credit enhancements obtained during the reporting period and held at the reporting date, including the nature and carrying amount of the assets and policy for disposing of assets not readily convertible into cash.

The following information about **liquidity risk** must be disclosed.

- (a) A maturity analysis for non-derivative financial liabilities that shows the remaining contractual maturities.
- (b) A maturity analysis for derivative financial liabilities.
- (c) A description of how liquidity risk is managed.

The following information about **market risk** must be disclosed.

- (a) A sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date.
- (b) The methods and assumptions used in preparing the sensitivity analysis
- (c) Changes in these methods and assumptions from the previous period.

## 8 Related Interpretation



**One Interpretation relevant to financial instruments is examinable: IFRIC 19 *Extinguishing financial liabilities with equity instruments*.**

IFRIC 19 provides guidance on accounting for 'debt for equity swaps', ie where a the terms of a financial liability are renegotiated with the result that a debtor extinguishes a liability by issuing equity instruments to a creditor.

The Interpretation provides accounting guidance for the debtor company

## 8.1 Accounting treatment

The Interpretation concludes that the issue of equity instruments to extinguish a liability is consideration paid.

- (a) The equity instruments are initially measured at their fair value unless the fair value cannot be reliably measured. In this case, the equity instruments are measured at the fair value of the financial liability extinguished.
- (b) The difference between the carrying amount of the financial liability and the consideration paid is recognised in profit or loss.



## CHAPTER ROUNDUP

- ↪ **Accounting for financial instruments is a complex area, with requirements coming from a number of accounting standards.**
- ↪ **A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity in another entity. LKAS 32 establishes the principles for establishing whether an instrument is a financial liability or equity.**
- ↪ **LKAS 39 *Financial instruments: recognition and measurement* provides guidance on when to recognise and when to derecognise a financial instrument.**
- ↪ **There are four categories of financial asset: fair value through profit or loss, held-to-maturity, available-for-sale and loans and receivables.**
- ↪ **There are two categories of financial liability: financial liabilities at fair value through profit or loss and other liabilities.**
- ↪ **A derivative is a financial instrument:**
  - **Whose value changes in response to the change in price of an underlying security, commodity, currency, index or other financial instrument**
  - **Where the initial net investment is zero or very small**
  - **That is settled at a future date**
- ↪ **SLFRS 7 contains the disclosure requirements for financial instruments.**
- ↪ **One Interpretation relevant to financial instruments is examinable: IFRIC 19 *Extinguishing financial liabilities with equity instruments*.**


**PROGRESS TEST**

- 1 What are the four categories of financial asset in LKAS 39?
- 2 Which of these are measured at fair value?
- 3 How is convertible debt initially recognised and measured?
- 4 How is an impairment loss on an available-for-sale asset calculated?
- 5 What is a derivative?
- 6 Is an embedded derivative always accounted for separately from the host contract?
- 7 A company issues Rs. 80m redeemable debt on 1 January 20X4, raising proceeds of Rs. 75m. Transaction costs incurred were Rs. 3m. The debt has a coupon rate of 4% and an effective interest rate of 6%. What is the carrying amount of the debt at 31 December 20X4?
  - A Rs. 81,600,000
  - B Rs. 79,480,000
  - C Rs. 73,120,000
  - D Rs. 76,300,000
- 8 A company acquired shares in a trading partner on 1 September 20X3 as part of a long-term strategy to gain significant influence. The cost of the investment was Rs. 210m and transaction costs amounted to Rs. 5m. The shares had a fair value of Rs. 201m at 31 December 20X3.  
 What amount is recognised in profit or loss in the year ended 31 December 20X5?
  - A Nil
  - B Rs. 4m
  - C Rs. 5m
  - D Rs. 14m
- 9 Which of the following statements is true?
  - A SLFRS 9 classifies financial assets as one of four types.
  - B LKAS 32 requires that details of the nature and extent of risks associated with financial instruments are disclosed.
  - C LKAS 39 requires that compound instruments are split-accounted.
  - D LKAS 39 requires that all remaining held-to-maturity financial assets are reclassified to become available-for-sale where a held-to-maturity asset is reclassified.

## ANSWERS TO PROGRESS TEST

- 1
  - Fair value through profit or loss
  - Held-to-maturity
  - Available-for-sale
  - Loans and receivables
- 2
  - Fair value through profit or loss (changes recognised in profit or loss)
  - Available-for-sale (changes recognised in other comprehensive income)
- 3 It is a hybrid financial instrument including a liability and equity and must be split-accounted.
  - (a) The liability component is measured by discounting cash flows at an interest rate applicable to similar debt without a conversion option.
  - (b) The equity component is the residual.
- 4 It is the difference between acquisition cost and current fair value less any impairment losses already recognised.
- 5 A derivative is a financial instrument whose value is related to an underlying item, that has a zero (or very small) initial cost and that will be settled in the future.
- 6 No – not if:
  - The economic characteristics and risks of the embedded derivative are not closely related to those of the host contract
  - A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative
  - The hybrid instrument is not measured at fair value with changes recognised in profit or loss (in which case there is no benefit to separating the embedded derivative)
- 7 The answer is **C**. The debt is initially recognised at proceeds of Rs. 75m less transaction costs of Rs. 3m, ie Rs. 72m.

	Rs'000
1 January	72,000
Finance cost ( $72\text{m} \times 6\%$ )	4,320
Interest paid ( $80\text{m} \times 4\%$ )	<u>(3,200)</u>
At 31 December	73,120

- 8 The answer is **A**. The investment is not held for trading and so is classified as available-for-sale. Therefore, transaction costs are added to the initial measurement of the investment to give Rs. 215m. The Rs. 14m loss on the shares is recognised in other comprehensive income.

**9** The answer is **D**.

**SLFRS 9** classifies financial assets as one of **two** types.

**SLFRS 7** requires that details of the nature and extent of risks associated with financial instruments are disclosed.

**LKAS 32** requires that compound instruments are split-accounted.





# Employee Benefits

## INTRODUCTION

An increasing number of companies and other entities now provide a **pension and other benefits** in addition to salaries and wages as part of their employees' remuneration package. In view of this trend, it is important that there is standard best practice for the way in which employee benefit costs are **recognised, measured, and presented** in the sponsoring entities' accounts.

Knowledge Component			
2	Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)		
2.2	Level B	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.

Knowledge Component			
2.3	Level C	2.3.1	Explain the concepts/principles of Sri Lanka Accounting Standards.
		2.3.2	Apply the concepts/principles of the standards to resolve a simple/straightforward matter.
		2.3.3	List the disclosures to be made in the financial statements.

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1 Introduction and definitions	2.2, 2.3
2 Short-term employee benefits	2.2, 2.3
3 Post-employment benefits	2.2, 2.3
4 Defined contribution plans	2.2, 2.3
5 Defined benefit plans	2.2, 2.3
6 Other long-term benefits	2.2, 2.3

**LKAS 19 Learning objectives**

- Explain short-term benefits and recognition, and measurement of short-term benefits.
- Compare and contrast the difference between defined contribution plans and defined benefit plans.
- Assess the recognition and measurement of defined benefit plans and defined contribution plans.
- Explain recognition and measurement of other long-term employee benefits.
- Outline presentation and disclosures pertaining to defined contribution plans and defined benefit plans.

**1 Introduction and definitions**

**LKAS 19 *Employee benefits* deals with the benefits awarded to employees as part of their remuneration package. These benefits may include short-term benefits such as sick pay, long-term benefits such as disability benefit, post-employment benefits such as pensions and termination benefits.**

Some basic LKAS 19 definitions in relation to employee benefits were introduced at the KE1 level, together with the recognition and measurement requirements in respect of short-term benefits. At KB1, we expand on this knowledge to consider the recognition and measurement requirements of the standard in respect of pensions and long-term benefits.

First we shall recap KE1 assumed knowledge.

## 1.1 Employee benefits

Employee benefits are all forms of consideration given by an entity in exchange for services performed by employees.

LKAS 19 *Employee benefits* recognises four categories of employee benefits. These four categories are as follows.

- (1) **Short-term benefits**, eg salaries, sick leave, maternity leave and annual leave
- (2) **Post-employment benefits**, eg pensions and post-employment medical care and post-employment insurance
- (3) **Other long-term benefits**, eg sabbatical leave and disability benefits
- (4) **Termination benefits**, eg early retirement payments and redundancy payments

Benefits may be paid to the employees themselves, to their dependants (spouses and children etc) or to third parties.

## 1.2 Definitions

LKAS 19 formally defines these categories of employee benefit as follows.



**Short-term employee benefits** are employee benefits (other than termination benefits) that are expected to be settled wholly before 12 months after the end of the annual reporting period in which the employees render the related service.

**Post-employment benefits** are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.

**Other long-term employee benefits** are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

**Termination benefits** are employee benefits provided in exchange for the termination of an employee's employment as a result of either of the following:

- (a) A company decision to terminate an employee's employment before the normal retirement date
- (b) An employee's decision to accept an offer of benefits in exchange for termination

## 2 Short-term employee benefits



Accounting for short-term employee benefits is fairly straightforward; there are **no specific disclosure requirements for short-term employee benefits** in the standard.

### 2.1 Recognition and measurement

Short-term employee benefit costs are recognised as employee costs in the employer's financial statements in the period in which employee service is given (unless these costs can be capitalised, for example as part of a non-current asset).

Unpaid short-term employee benefits at the end of an accounting period are recognised as an accrued expense.

Any short-term benefits paid in advance are recognised as a prepayment (to the extent that it will lead to, for example, a reduction in future payments or a cash refund).

### 2.2 Short-term absences

LKAS 19 classifies short-term paid absences as non-accumulating or accumulating paid absences.

Non-accumulating paid absences	Accumulating paid absences
Do not carry forward if unused in the current period.	Carry forward to the next period if unused in the current period.
Eg maternity pay and sick pay.	Eg some employers allow unused paid holiday leave to be carried forward.
↓	↓
Expense is recognised when absence occurs.	Expense is recognised when employee renders service which increases their entitlement to paid absences.



#### QUESTION

#### Holiday leave

Abekoon Traders (Pvt) Ltd gives its employees an annual entitlement to paid holiday leave. If there is any unused leave at the end of the year, employees are entitled to carry forward the unused leave for up to 12 months. At 31 December 20X3, the company's employees carried forward in total 35 days of unused

holiday leave. Employees are paid Rs. 400 per day. Abekoon Traders expects all employees to use their carried forward holiday entitlement before the end of 20X4.

### Required

**Record** the amounts recognised in the financial statements of Abekoon Traders for the year ended 31 December 20X3 in respect of the unused leave.

### ANSWER

<b>Statement of profit or loss</b>	Rs
Staff costs ( $400 \times 35$ )	14,000
<b>Statement of financial position</b>	
Accrued leave	14,000



### QUESTION

#### Sick leave

Adikari Fisheries Ltd has 300 employees. Each is entitled to seven working days of paid sick leave for each year, and unused sick leave can be carried forward for one year. Sick leave is taken on a last in, first out (LIFO) basis, ie firstly out of the current year's entitlement and then out of any balance brought forward.

As at 31 December 20X4, the average unused entitlement is four days per employee. Adikari Fisheries expects (based on past experience, which is expected to continue) that 285 employees will take five days or less sick leave in 20X5, the remaining 15 employees will take an average of 10 days each.

### Required

**State** the required accounting for sick leave for the year ended 31 December 20X4.

### ANSWER

Adikari Fisheries expects to pay an additional 45 days of sick pay as a result of the unused entitlement that has accumulated at 31 December 20X4, ie  $3 \text{ days} \times 15 \text{ employees}$ . For the year ended 31 December 20X4, Adikari Fisheries should recognise a liability and corresponding expense equal to 45 days of sick pay.

## 2.3 Profit sharing or bonus plans

Profit shares or bonuses payable within 12 months after the end of the accounting period should be recognised as an expense and a liability when the entity has a

**present obligation to pay them**, ie when the employer has no real option but to pay. This will usually be when the employer recognises the profit or other performance achievement to which the profit share or bonus relates. The measurement of the liability reflects the possibility that some employees may leave without receiving a bonus.



## QUESTION

### Profit sharing

Hippala Homewares (Pvt) Ltd runs a profit sharing plan, under which it pays 5% of its net profit for the year to those employees who have not left during the year. Kandy Trading Co estimates that this will be reduced by staff turnover to 4.2% in 20X9.

### Required

**State** what amounts should be recognised by Hippala Homewares for the profit share in 20X9.

## ANSWER

Hippala Homewares should recognise a liability and an expense of 4.2% of net profit.

## 3 Post-employment benefits



The most common type of post-employment benefit is a pension. There are two types of post-employment benefit plan:

- Defined contribution plans
- Defined benefit plans

Post-employment benefit schemes are often referred to as **plans**. The plan receives regular contributions from the employer (and sometimes from current employees as well) and the money is invested in assets, such as stocks and shares and other investments.

The post-employment benefits are paid out of the income from the plan assets (dividends and interest) or from money from the sale of some plan assets. Benefits may take the form of pensions, post-employment life assurance or medical care.

### 3.1 Defined contribution and defined benefit plans

LKAS 19 sets out the following definitions relating to classification of plans.



**Defined contribution plans** are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

**Defined benefit plans** are post-employment benefit plans other than defined contribution plans.

#### 3.1.1 Defined contribution plans.

In the case of a defined contribution plan, the employer (and possibly current employees) pays fixed amounts into the plan each year. The contributions are invested, and the size of the post-employment benefits paid to former employees depends on how well or how badly the investments of the plan perform.

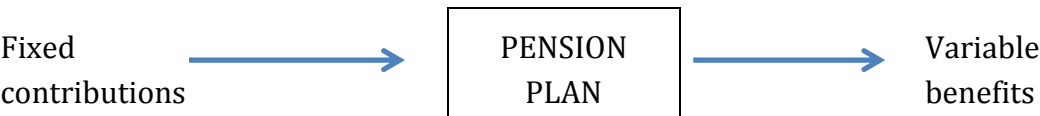


Figure 15.1

#### 3.1.2 Defined benefit plans.

In the case of a defined benefit plan, the size of the post-employment benefits is fixed and the employer (and possibly current employees) pays contributions into the plan, which are invested. The size of the contributions is set at an amount that is expected to earn enough investment returns to meet the obligation to pay the post-employment benefits.

If the assets in the fund are insufficient, the employer will be required to make additional contributions into the plan to make up the expected shortfall; if the fund assets appear to be larger than they need to be, and in excess of what is required to pay the post-employment benefits, the employer may be allowed to take a **contribution holiday** (ie stop paying in contributions for a while).

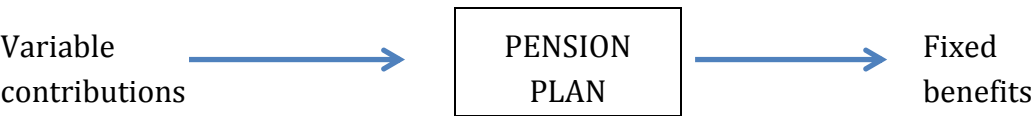


Figure 15.2



## 3.2 Multi-employer plans

A multi-employer plan is a retirement benefit plan run for the benefit of several entities: various entities contribute to the pool, and the employees of those entities benefit on retirement.

Multi-employer plans may be defined contribution plans or defined benefit plans. A multi-employer defined contribution plan is accounted for in the normal way (see Section 4); a multi-employer defined benefit plan is accounted for in the normal way (see Section 5), but only to the extent to which an entity participates in it. If the extent to which an entity participates cannot be established, then the plan is accounted for as if it were a defined contribution plan and additional disclosures must be made.

## 4 Defined contribution plans



A defined contribution plan involves specific contributions being paid into a pension plan, with the result that benefits are variable depending on how the plan has performed. The contributions are accounted for as an expense.

### 4.1 Recognition and measurement

#### 4.1.1 Statement of profit or loss

Contributions to a defined contribution plan are recognised as an expense in the period in which they are payable (unless labour costs are included in the cost of assets such as property under construction).

#### 4.1.2 Statement of financial position

Any unpaid contributions that are due at the end of a period are recognised as an accrued expense (liability).

Any excess contributions are recognised as a prepaid expense (asset) to the extent that the prepayment will result in a reduction in future payments or a refund.



### QUESTION

#### Defined contribution plan

Pacific Plants Ltd contributes 5% of employees' salaries into a post-employment plan each period. Salaries amounted to Rs. 8m in the year ended 31 March 20X4 and the company had paid Rs. 350,000 into the plan by the reporting date.

**Required**

**Prepare** the journal entry made by Pacific Plants Ltd in the year ended 31 March 20X4 to recognise pension costs.

**ANSWER**

DEBIT	Staff costs (SPL) ( $5\% \times 8m$ )	400,000	
CREDIT	Cash		350,000
CREDIT	Pension cost accrual		50,000

**4.2 Disclosures**

LKAS 19 requires that the following disclosures are made in respect of defined contribution plans:

- (a) A description of the plan
- (b) The amount recognised as an expense in the period

**5 Defined benefit plans**

A defined benefit plan involves a specific pension benefit being paid on retirement. Contributions to the plan therefore vary depending on how well the plan is performing and changes in assumptions such as retirement age. Defined benefit plans are recognised in the statement of financial position.

As discussed in Section 3, contributions to defined benefit pension plans are variable; it would therefore not be appropriate to recognise them as an expense in the same way as contributions to defined contribution plans.

Instead, LKAS 19 requires that a net defined benefit plan asset or liability is recognised in the statement of financial position at each reporting date and movements in this net amount from year to year are recognised in the statement of profit or loss and other comprehensive income.

The net defined benefit asset or liability is calculated as

	Rs
Present value of defined benefit obligation (obligation to pay future benefits to employees)	X
Fair value of plan assets	<u>(X)</u>
Net defined benefit liability/(asset)	X/(X)

Where a net defined benefit liability results, this is sometimes referred to as a deficit; where there is a net defined benefit asset, this is a surplus.

LKAS 19 makes it very clear that the defined benefit obligation refers not only to the legal obligation under the formal terms of a defined benefit plan that an entity must account for, but also for any **constructive obligation** that it may have. A constructive obligation, which will arise from the entity's informal practices, exist when the entity has no realistic alternative but to pay employee benefits; for example, if any change in the informal practices would cause unacceptable damage to employee relationships.

## 5.1 Definitions

Before considering the recognition and measurement of defined benefit plans, the following definitions are relevant.



**The net defined benefit liability (asset)** is the deficit or surplus adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

The **deficit or surplus** is:

- (a) The present value of the defined benefit obligation less
- (b) The fair value of plan assets (if any)

The **asset ceiling** is the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

The **present value of a defined benefit obligation** is the present value, without deducting any plan assets, of expected future payments required to settle the obligation from employee service in the current and prior periods.

**Plan assets** comprise:

- (a) Assets held by a long-term employee benefit fund
- (b) Qualifying insurance policies

**Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Service cost** comprises:

- (a) Current service cost, which is the increase in the present value of the defined benefit obligation resulting from employee service in the current period
- (b) Past service cost, which is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment or a curtailment
- (c) Any gain or loss on settlement

**Net interest on the net defined benefit liability (asset)** is the change during the period in the net defined benefit liability (asset) that arises from the passage of time.

**Remeasurements** of the net defined benefit liability (asset) comprise:

- (a) Actuarial gains and losses
- (b) The return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset)
- (c) Any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset)

**Actuarial gains and losses** are changes in the present value of the defined benefit obligation resulting from:

- (a) Experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred)
- (b) The effects of changes in actuarial assumptions

## 5.2 Accounting steps

LKAS 19 prescribes a 4-step approach to accounting for a defined benefit plan, as outlined below. Each step will be explained in more detail later.

### **Step 1 Measure the deficit or surplus:**

- (a) An actuarial technique is used to make a reliable estimate of the cost to the entity of providing the post-employment benefit earned by employees in the current and prior periods.
- (b) The benefit is discounted to arrive at the present value of the defined benefit obligation.
- (c) The fair value of any plan assets is deducted from the present value of the defined benefit obligation.

### **Step 2 Determine the amount of the net defined benefit liability or asset**

The surplus or deficit measured in Step 1 may have to be adjusted if a net benefit asset has to be restricted by the asset ceiling.

### **Step 3 Determine the amounts to be recognised in profit or loss**

These may include:

- (a) Current service cost
- (b) Any past service cost and gain or loss on settlement
- (c) Net interest on the net defined benefit liability (asset)

**Step 4 Determine remeasurements to be recognised in other comprehensive income (items that will not be reclassified to profit or loss)**

These may include:

- (a) Actuarial gains and losses
- (b) Return on plan assets (excluding amounts included in net interest on the net defined benefit liability (asset))
- (c) Any change in the effect of the asset ceiling (excluding amounts included in net interest on the net defined benefit liability (asset))

### **5.3 Measure the deficit or surplus**

The present value of the defined benefit obligation and the fair value of plan assets are usually measured by an actuary (although this is not required by LKAS 19).

This process need not take place each year; however it should take place with sufficient regularity that reported amounts are not materially different from the actual value at the reporting date.

#### **5.3.1 Estimate of cost of future benefits**

The cost of providing future benefits is estimated using the projected unit credit method. This method assumes that each period of employee service results in an additional unit of future benefit. These are measured separately and then added together to measure the total obligation.

In estimating the obligation, the actuary is required to make a number of assumptions (actuarial assumptions) about retirement ages, salary rises, the mortality rate and so on.

#### **5.3.2 Discount the total obligation to present values**

The total obligation is discounted to present values using a rate determined by reference to market yields at the end of the reporting period on high-quality corporate bonds.

#### **5.3.3 Deduct the fair value of plan assets**

Plan assets are measured at fair value, being the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

- Plan assets should exclude contributions due from an employer but not yet paid.
- Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits such as trade payables.

## 5.4 Determine the amount of the net defined benefit liability or asset

The net defined benefit liability or asset is measured as the present value of the defined benefit obligation at the reporting date minus the fair value of the plan assets at the reporting date.

Where the resulting net amount is a surplus (the fair value of the assets exceeds the present value of the obligation), the amount of the surplus that is recognised may be limited by the asset ceiling.

The asset ceiling is 'the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan'. In other words, a recognised net defined benefit pension asset is restricted to the amount of cash savings available to an entity in the future.

### 5.4.1 IFRIC 14

IFRIC 14 IAS 19 – *The limit on a defined benefit asset, minimum funding requirements and their interaction* clarifies the meaning of 'available' economic benefits in the context of the calculation of the asset ceiling. It states that:

- Available economic benefits are not necessarily taken as a refund or a reduction in contributions – they may be used to increase benefits.
- Economic benefits are available if the entity can realise them during the life of the plan or when the liabilities are settled.
- Economic benefits must be unconditional, ie they cannot be contingent on factors beyond the entity's control.



### 5.4.2 Example: asset ceiling

Asiacall Ltd operates a defined benefit pension for its employees. At 31 December 20X3 the company was advised by actuaries that the fair value of plan assets was Rs. 19.3m, the present value of the defined benefit obligation was Rs. 16.4m and the present value of future economic benefits in relation to the plan was Rs. 2.7m.

**Required**

What amount is recognised in the statement of financial position of Asiatic Ltd at 31 December 20X3 in respect of the defined benefit plan?

**Solution**

The surplus is calculated as:

	Rs'000
Present value of defined benefit obligations	16,400
Fair value of plan assets	<u>(19,300)</u>
Surplus	(2,900)

The recognised surplus is restricted to the Rs. 2.7m asset ceiling.

The difference between the calculated surplus and the asset ceiling is dealt with as a remeasurement (see Section 5.6).

**5.5 Determine the amounts to be recognised in profit or loss**

The difference between the net defined benefit asset or liability at the start of a period and the end of a period can be attributed to:

- (a) Contributions into the plan
- (b) Payments out of the plan
- (c) Service costs
- (d) Net interest on the defined benefit asset or liability
- (e) Remeasurements

The first two of these do not affect the statement of profit or loss and other comprehensive income; they are recognised in the reporting entity's books by:

*Contributions into the plan*

DEBIT      Fair value of plan assets  
CREDIT    Cash

*Payments out of the plan*

DEBIT      Present value of defined benefit obligation  
CREDIT    Fair value of plan assets

The second two are recognised in profit or loss (see Sections 5.5.1 and 5.5.2) and the final one is recognised in other comprehensive income (see Section 5.6).

5.5.1 Service costs

Service costs include current service cost, past service cost and gains or losses on settlement of a defined benefit plan.

- (a) Current service cost is the increase in the present value of the defined benefit obligation as a result of employees rendering service in the current period (more years' service results in more benefit on retirement). This is relevant to all defined pension plans and is recognised by:

DEBIT    Operating expenses (staff costs)  
CREDIT   Present value of defined benefit obligation

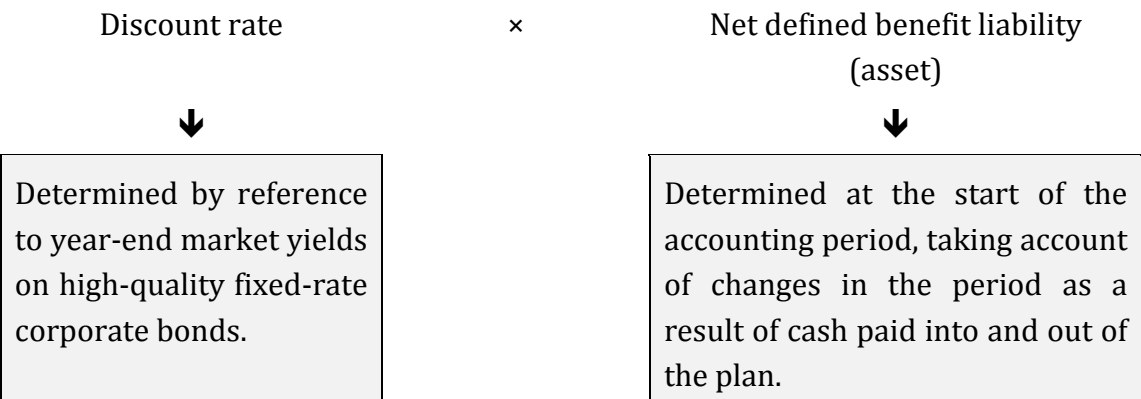
- (b) Past service cost is the change in the present value of the defined benefit obligation as a result of amendments or curtailments to the pension plan. These are not relevant to all plans and are considered in more detail in Section 5.8.
- (c) Gains or losses on settlement of a defined benefit plan are not relevant to all plans and are considered in more detail in Section 5.9.

5.5.2 Net interest on the defined benefit asset or liability

Interest arises on both elements of the pension plan:

- Interest income is the return on plan assets
- Interest expense is the unwinding of the discount on the defined benefit obligation

These two elements of interest must be calculated on a net basis as:



Practically, interest can be calculated separately on the fair value of plan assets and the present value of the defined benefit obligation; however, the same discount rate is used for each.



Net interest is recognised in profit or loss by:

DEBIT Fair value of plan assets

CREDIT Interest income (SPL)

And

DEBIT Interest expense (SPL)

CREDIT Present value of defined benefit obligation

## 5.6 Determine remeasurements to be recognised in other comprehensive income

Remeasurements may be positive (a gain) or negative (a loss) and include:

- Actuarial gains and losses
- The return on plan assets (excluding amounts included in net interest on the net defined benefit liability)
- Any change in the effect of the asset ceiling (again excluding amounts included in net interest on the net defined benefit liability)

These are recognised in other comprehensive income and are never reclassified to profit or loss.

### 5.6.1 Actuarial gains and losses

When measuring a defined benefit plan, an actuary is required to make a number of assumptions, as we saw in Section 5.3.1.

At the end of each accounting period, a new valuation is carried out on the defined benefit plan using updated assumptions. Actuarial gains or losses arise because changes in assumptions and experience adjustments, for example:

- **Actual events** (eg employee turnover and salary increases) differ from the actuarial assumptions that were made to estimate the defined benefit obligations
- The effect of **changes to assumptions** concerning benefit payment options
- **Estimates are revised** (eg different assumptions are made about future employee turnover, salary rises, mortality rates and so on)
- The effect of changes to the **discount rate**

### 5.6.2 Return on plan assets

A new valuation of the plan assets is carried out at each period end, using current fair values. Any difference between the new value, and what has been recognised up to that date (normally the opening balance, interest, and any cash payments into or out of the plan) is treated as a 'remeasurement' and recognised in other comprehensive income.

### 5.6.3 Change in the effect of the asset ceiling

In Section 5.4, we saw that where a plan is in surplus, the reported amount may be restricted by the asset ceiling. Where this is the case, the related write down is recognised in other comprehensive income.



### 5.7 Example: accounting for a defined benefit plan

At 1 January 20X2 the fair value of the assets of a defined benefit plan were measured at Rs. 1,100,000, and the present value of the defined benefit obligation was Rs. 1,250,000. On 31 December 20X2, the plan received contributions from the employer of Rs. 490,000 and paid out benefits of Rs. 190,000.

The current service cost for the year was Rs. 360,000, and a discount rate of 6% is to be applied to the net liability/(asset).

After these transactions, the fair value of the plan's assets at 31 December 20X2 was Rs. 1.5m. The present value of the defined benefit obligation was Rs. 1,553,600.

#### Required

**Calculate** the gains or losses on remeasurement through OCI and the return on plan assets, and **demonstrate** how this pension plan will be treated in the statement of profit or loss and other comprehensive income and statement of financial position for the year ended 31 December 20X2.

### Solution

It is always useful to set up a working reconciling the assets and obligation:

	<i>Assets</i>	<i>Obligation</i>
	Rs	Rs
Fair value/present value at 1/1/X2	1,100,000	1,250,000
Interest $(1,100,000 \times 6\%) / (1,250,000 \times 6\%)$	66,000	75,000
Current service cost		360,000
Contributions received	490,000	
Benefits paid	(190,000)	( 190,000)
Return on plan assets excluding amounts in net interest (balancing figure) (OCI)	34,000	-
Loss on remeasurement (balancing figure) (OCI)	-	58,600
	<u>1,500,000</u>	<u>1,553,600</u>

The following accounting treatment is required.

- (a) In the **statement of profit or loss and other comprehensive income**, the following amounts will be recognised

In **profit or loss**:

	Rs
Current service cost	360,000
Net interest on net defined benefit liability $(75,000 - 66,000)$	9,000

In **other comprehensive income**  $(34,000 - 58,600)$  24,600

- (b) In the **statement of financial position**, the net defined benefit liability of Rs. 53,600  $(1,553,600 - 1,500,000)$  will be recognised.

## 5.8 Past service costs

Past service costs arise where a defined benefit plan:

- Is amended, eg a new plan is introduced, an existing plan is withdrawn or benefits payable are changed.
- Is curtailed such that the number of employees covered by a plan is reduced.

The past service cost is the change in the present value of the defined benefit plan as a result of the amendment or curtailment.

Past service costs are recognised in profit or loss at the earlier of:

- When the amendment or curtailment occurs
- When related restructuring costs are recognised in accordance with HKAS 37 or termination benefits in accordance with HKAS 19

## 5.9 Gains and losses on settlements

A settlement arises when all or part of a post-employment benefit obligation is eliminated by an employer.

The gain or loss on settlement is calculated as the difference between:

- (a) The present value of the defined benefit obligation being settled, valued at the date of settlement
- (b) The settlement price

Resulting gains and losses are recognised immediately in profit or loss.

## 5.10 Disclosure

A reporting entity with a defined benefit pension plan should disclose information that:

- (a) Explains the characteristics of its defined benefit plans and risks associated with them
- (b) Identifies and explains the amounts in its financial statements arising from defined benefit plans
- (c) Describes how defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows

### 5.10.1 Characteristics and risks

- (a) Characteristics of the plan should be disclosed including the nature of benefits provided, a description of the regulatory framework in which the plan operates and a description of any other entity's responsibilities for the governance of the plan.
- (b) A description of the risks to which the plan exposes the entity should be provided with a focus on unusual, entity or plan-specific risks and concentrations of risk.
- (c) A description of plan amendments, curtailments and settlements should be disclosed.

### 5.10.2 Explanation of amounts in financial statements

In the statement of financial position, the net defined benefit liability/asset is recognised, subject to the asset ceiling if it is an asset.

A reconciliation should be provided in the notes to the accounts for each of:

- Plan assets
- The present value of the defined benefit obligation
- The effect of the asset ceiling

In addition:

- The fair value of plan assets should be separated into classes that distinguish the nature and risks of those classes of assets.
- Significant actuarial assumption used to determine the present value of the defined obligation should be disclosed.

### 5.10.3 Amount, timing and uncertainty of cash flows

A sensitivity analysis for each significant actuarial assumption at the end of the reporting period should be disclosed with a description of methods and assumptions used to prepare it and changes in these methods and assumptions from the previous period.

An indication of the effect of the plan on future cash flows is provided by disclosing a description of funding arrangements, expected contributions to the plan in the next period and information about the maturity profile of the defined benefit obligation.

## 5.11 Summary of accounting treatment

Step	Item	Recognition
1	<b>Record opening figures</b> <ul style="list-style-type: none"> <li>• FV of plan assets</li> <li>• PV of defined benefit obligation</li> </ul>	
2	<b>Interest cost on obligation</b> <ul style="list-style-type: none"> <li>• Based on discount rate and PV obligation at start of period</li> <li>• Should also reflect any changes in obligation during period</li> </ul>	DEBIT Interest cost (SPL) (x% × obligation) CREDIT PV defined benefit obligation
3	<b>Interest on plan assets</b> <ul style="list-style-type: none"> <li>• Based on discount rate and asset value at start of period</li> <li>• Should reflect changes in the period</li> </ul>	DEBIT FV of plan assets CREDIT Interest cost (SPL) (x% × asset)

Step	Item	Recognition
4	<b>Current service cost</b> <ul style="list-style-type: none"> <li>Increase in the present value of the obligation resulting from employee service in the current period</li> </ul>	DEBIT Current service cost (SPL) CREDIT PV defined benefit obligation
5	<b>Contributions</b> <ul style="list-style-type: none"> <li>As advised by actuary</li> </ul>	DEBIT FV of plan assets CREDIT Cash
6	<b>Benefits</b> <ul style="list-style-type: none"> <li>Actual pension payments made</li> </ul>	DEBIT PV defined benefit obligation CREDIT FV of plan assets
7	<b>Past service cost</b> <ul style="list-style-type: none"> <li>Increase/decrease in PV obligation as a result of introduction or improvement of benefits</li> </ul>	<b>Positive (increase in obligation):</b> DEBIT Past service cost (SPL) CREDIT PV defined benefit obligation <b>Negative (decrease in obligation):</b> DEBIT PV defined benefit obligation CREDIT Past service cost (SPL)
8	<b>Gains and losses on settlement</b> <ul style="list-style-type: none"> <li>Difference between the value of the obligation being settled and the settlement price</li> </ul>	<b>Gain</b> DEBIT PV defined benefit obligation CREDIT Service cost (SPL) <b>Loss</b> DEBIT Service cost (SPL) CREDIT PV defined benefit obligation

Step	Item	Recognition
9	<b>Remeasurements: actuarial gains and losses</b> <ul style="list-style-type: none"> <li>• Arising from annual valuations of obligation</li> <li>• On obligation, differences between actuarial assumptions and actual experience during the period, or changes in actuarial assumptions</li> </ul>	<b>Gain</b> DEBIT PV defined benefit obligation CREDIT Other comprehensive income <b>Loss</b> DEBIT Other comprehensive income CREDIT PV defined benefit obligation
10	<b>Remeasurements: return on assets (excluding amounts in net-interest)</b> <ul style="list-style-type: none"> <li>• Arising from annual valuations of plan assets</li> </ul>	<b>Gain</b> DEBIT FV of plan assets CREDIT Other comprehensive income <b>Loss</b> DEBIT Other comprehensive income CREDIT FV of plan assets
11	<b>Disclose in accordance with the standard</b>	



## QUESTION

### Defined contribution plan

Colombo Creations Ltd provides a defined benefit pension scheme for its employees. At 31 December 20X3 and 20X4, plan assets and the defined benefit obligation were measured by actuaries as follows.

	20X3	20X4
	Rs'000	Rs'000
Fair value of plan assets	14,000	14,300
Present value of obligation	15,300	17,600

The following information is relevant to the year ended 31 December 20X4:

- Contributions to the scheme amounted to Rs. 800,000, paid on 31 December
- Benefits paid out on 31 December were Rs. 1,200,000
- The current service cost was Rs. 1,400,000
- A relevant discount rate is 6%

- The rules of the plan were changed on 1 January 20X4 to increase pension benefits and as a result the defined benefit obligation on the new basis was Rs. 16,200,000

### Required

**Record** the amounts recognised in the financial statements of Colombo Creations in the year ended 31 December 20X4.

### ANSWER

The movement in the defined benefit plan is as follows:

	<i>FV of plan assets</i>	<i>PV of obligation</i>
	Rs'000	Rs'000
At 31 December 20X3	14,000	14,700
Past service cost		<u>1,500</u>
	14,000	16,200
Contributions	800	-
Benefits	(1,200)	(1,200)
Current service cost		1,400
Net interest at 6% on opening balance	840	972
	14,440	17,372
Remeasurements	<u>(140)</u>	<u>228</u>
	14,300	17,600

### Statement of financial position at 31 December 20X4

	Rs '000
Net defined benefit deficit (17,600 – 14,300)	3,300

### Statement of profit or loss and other comprehensive income at 31 December 20X4

	Rs'000
Operating expenses (1,500 + 1,400)	2,900
Interest costs (972 – 840)	132
Other comprehensive income – remeasurements (228 + 140)	368

## 6 Other long-term benefits



Other long-term benefits include sabbatical leave and disability benefits. They are accounted for in a similar way to post-employment benefits.

LKAS 19 defines other long-term employee benefits as all employee benefits other than short-term employee benefits, post-employment benefits and termination



benefits if not expected to be settled wholly before 12 months after the end of the annual reporting period in which the employees render the related service.

The types of benefits that might fall into this category include:

- (a) Long-term paid absences such as long-service or sabbatical leave
- (b) Jubilee or other long-service benefits
- (c) Long-term disability benefits, profit-sharing and bonuses
- (d) Deferred remuneration

## 6.1 Accounting treatment for other long-term benefits

There are many similarities between these types of benefits and defined benefit pensions. For example, in a long-term bonus scheme, the employees may provide service over a number of periods to earn their entitlement to a payment at a later date. In some case, the entity may put cash aside, or invest it in some way (perhaps by taking out an insurance policy) to meet the liabilities when they arise.

As there is normally far less uncertainty relating to the measurement of these benefits, LKAS 19 requires a simpler method of accounting for them. Unlike the accounting method for post-employment benefits, this method does not recognise re-measurements in other comprehensive income.

The entity should recognise all of the following in **profit or loss**:

- (a) Service cost
- (b) Net interest on the defined benefit liability (asset)
- (c) Remeasurement of the defined benefit liability (asset)



## CHAPTER ROUNDUP

- ↪ **LKAS 19 *Employee benefits* deals with the benefits awarded to employees as part of their remuneration package. These benefits may include short-term benefits such as sick pay, long-term benefits such as disability benefit, post-employment benefits such as pensions and termination benefits.**
- ↪ Accounting for short-term employee benefits is fairly straightforward; there are **no specific disclosure requirements for short-term employee benefits** in the standard.
- ↪ The most common type of post-employment benefit is a pension. There are two types of post-employment benefit plan:
  - Defined contribution plans
  - Defined benefit plans
- ↪ A defined contribution plan involves specific contributions being paid into a pension plan, with the result that benefits are variable depending on how the plan has performed. The contributions are accounted for as an expense.
- ↪ A defined benefit plan involves a specific pension benefit being paid on retirement. Contributions to the plan therefore vary depending on how well the plan is performing and changes in assumptions such as retirement age. Defined benefit plans are recognised in the statement of financial position.
- ↪ Other long-term benefits include sabbatical leave and disability benefits. They are accounted for in a similar way to post-employment benefits.

**PROGRESS TEST**

- 1 What are the four categories of employee benefits covered by LKAS 19?
- 2 What is the difference between defined contribution and defined benefit plans?
- 3 How are contributions to a defined contribution scheme accounted for?
- 4 What amounts are recognised in profit or loss in respect of a defined benefit plan?
- 5 What amounts are recognised in other comprehensive income in respect of a defined benefit plan?
- 6 Where are remeasurements in respect of other long-term benefits recognised?

## ANSWERS TO PROGRESS TEST

- 1
  - Short-term
  - Post-employment
  - Other long-term
  - Termination
- 2 Under a **defined contribution plan**, the employer agrees to pay an agreed amount of contributions and undertakes no further liability. Under a **defined benefit plan**, the employer agrees to pay an agreed level of benefits – if the plan assets are insufficient to meet the plan liabilities, the employer will have to make up the deficit.
- 3 As an expense in the period in which the employee has rendered service. Where contributions are due but not yet paid, then an accrual is recognised; where excess contributions have been paid, then a prepayment is recognised.
- 4 Service costs (both current and past) and gains or losses on settlements.
- 5 Remeasurements including actuarial gains and losses, the return on assets (excluding any amounts recognised as part of net interest on the net defined benefit surplus/deficit) and changes in the effect of the asset ceiling.
- 6 In profit or loss (unlike in the case of defined benefit pension plans when they are recognised as other comprehensive income).

# Share-based Payments

## INTRODUCTION

It is increasingly common for companies to pay employees in the form of share options. This is an example of a share-based payment.

SLFRS 2 applies to all share-based payments and was introduced to ensure consistency between companies that pay employees, and other parties, in cash, and those that pay in shares or share options.

### Knowledge Component

#### 2 Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)

2.3	Level C	2.3.1	Explain the concepts/principles of Sri Lanka Accounting Standards.
		2.3.2	Apply the concepts/principles of the standards to resolve a simple/straightforward matter.
		2.3.3	List the disclosures to be made in the financial statements.

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1 Introduction	2.3
2 Equity-settled share-based payments	2.3
3 Cash-settled share-based payments	2.3
4 Disclosure of share-based payments	2.3

**SLFRS 2 Learning objectives**

- State the recognition criteria of share-based payments.
- Define equity settled share-based payment and cash-settled share-based transactions.
- State vesting conditions and non-vesting conditions.
- Compute amounts to be included in the financial statements in respect of share-based payments.
- Outline the disclosures to be made in respect of share-based payments.
- Apply the methodology to be followed in identifying, measuring, recording and presenting a given share-based payment transaction in the financial statements for a given set of circumstances.

**1 Introduction**

**SLFRS 2** requires that share-based payment transactions are recognised in profit or loss in order to be consistent with the recognition of similar transactions for cash.

Transactions whereby companies purchase goods or services from other parties, such as suppliers and employees, by issuing shares or share options to those other parties are increasingly common. Share schemes are a common feature of director and executive remuneration and in some countries the authorities may offer tax incentives to encourage more companies to offer shares to employees.

The increasing use of share-based payments has raised questions about the accounting treatment of such transactions in company financial statements.

Share options are often granted to employees at an exercise price that is equal to or higher than the market price of the shares at the date the option is granted.

Consequently, the options have no intrinsic value and so historically no transaction was recorded in the financial statements.

This led to an anomaly: if a company paid its employees in cash, an expense was recognised in profit or loss, but if the payment was in share options, no expense was recognised.

SLFRS 2 addresses this issue by requiring that all share-based payment transactions are recognised in profit or loss.

## 1.1 Objective and scope of SLFRS 2

SLFRS 2 applies to all share-based payment transactions. There are three types.

- (a) **Equity-settled share-based payment transactions**, in which the entity receives goods or services in exchange for equity instruments of the entity (including shares or share options)
- (b) **Cash-settled share-based payment transactions**, in which the entity receives goods or services in exchange for amounts of cash that are based on the price (or value) of the entity's shares or other equity instruments of the entity
- (c) Transactions in which the entity receives or acquires goods or services and either the entity or the supplier has a **choice** as to whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments

In this chapter, we cover equity-settled and cash-settled share-based payments.

## 1.2 The recognition principle

An entity should recognise goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received.

Goods or services received or acquired in a share-based payment transaction should be recognised as expenses unless they qualify for recognition as assets. For example, services are normally recognised as expenses (because they are normally rendered immediately), while goods are recognised as assets.

If the goods or services were received or acquired in an equity-settled share-based payment transaction, the entity should recognise a corresponding increase in equity (reserves).

If the goods or services were received or acquired in a cash-settled share-based payment transaction, the entity should recognise a liability.

The following sections of the chapter deal with equity-settled and cash-settled share-based transactions in turn.

## 2 Equity-settled share-based payments



**Equity-settled share-based payments** are recognised as an expense or asset with a corresponding increase to equity.

### 2.1 Definitions

A number of definitions are provided by SLFRS 2 and are relevant to equity-settled share-based payments.



**An equity-settled share-based payment** is a share-based transaction in which an entity:

- (a) Receives goods or services as consideration for its own equity instruments (including shares or share options), or
- (b) Receives goods or services but has no obligation to settle the transaction with the supplier

**A share option** is a contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.

**The grant date** is the date at which the entity and another part (including an employee) agree to a share-based payment arrangement. At this date, the entity confers on the counterparty the right to cash, other assets or equity instruments of the entity, provided the specific vesting conditions are met.

**Vesting conditions** are the conditions that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement.

**The vesting period** is the period during which all the specified vesting conditions of a share based payment arrangement are to be satisfied.

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The following example demonstrates some of these definitions.



#### 2.1.1 Example: share options

The employees of Kalugala Trading PLC are issued with share options on 1 July 20X3 as part of their remuneration package. The share options can be exercised (and so shares purchased at the defined price) on 1 July 20X6, providing that the individuals remain within the employment of Kalugala Trading.



Grant date	1 July 20X3
Vesting date	1 July 20X6
Vesting period	1 July 20X3 – 1 July 20X6
Vesting condition	Continued employment

We have already determined that SLFRS 2 requires equity-settled share-based payments such as share options provided to employees to be recognised as an expense (or asset) with a corresponding increase to equity. The standard also provides guidance on:

- How the equity instruments should be measured
- When they should be recognised

## 2.2 Measurement of an equity-settled share-based payment transaction

The general principle in SLFRS 2 is that when an entity recognises the goods or services received and the corresponding increase in equity, it should measure these at the fair value of the goods or services received.

The application of this rule depends on who the transaction is with:

- Where the transaction is with employees and equity instruments are granted as part of their remuneration package, it is not normally possible to measure the services received. Therefore in this case the transaction is measured by reference to the fair value of the equity instruments granted at the grant date.
- Where the transaction is with a party other than an employee, there is a rebuttable presumption that the fair value of goods or services received can be estimated reliably.
- If the fair value of goods or services received cannot be estimated reliably, the transaction is measured by reference to the fair value of the equity instruments granted at the grant date.



### QUESTION **Measurement of equity-settled share-based payments**

Weerakoon Water PLC makes the following share-based payments.

- (1) One hundred employees were paid a proportion of their remuneration in share options. Two hundred options were granted to each employee on 1 August 20X1, at which date the fair value of a company share was Rs. 9 and the fair value of each share option was Rs. 2.50.
- (2) A supplier was paid 2,900 newly issued shares for goods supplied. The fair value of the goods supplied was Rs. 30,000 and on the date of payment the fair value of each share was Rs. 10.

#### **Required**

**Demonstrate** how these transactions are measured in accordance with SLFRS 2.

### ANSWER

- (1) The share options are measured at their fair value at the grant date, ie Rs. 50,000 ( $100 \times 200 \times 2.50$ ).
- (2) The shares are measured at the fair value of goods received, ie Rs. 30,000.

## **2.3 Recognition of an equity-settled share-based payment**

Where equity instruments granted by a company vest immediately (ie the counterparty is entitled to them immediately), then the transaction is recognised on the grant date.

Where equity instruments do not vest immediately and the counterparty has to meet specified vesting conditions, the transaction is recognised over the vesting period.

### **2.3.1 Transactions with parties other than employees**

Transactions with parties other than employees normally vest immediately. Therefore they are:

- Measured at the fair value of goods or services provided
- Recognised when the goods or services are provided

### 2.3.2 Transactions with employees

Transactions with employees often involve a vesting period. Therefore they are:

- Measured at the fair value of the equity instruments provided on the grant date
- Recognised over the vesting period

The expense recognised in each year of the vesting period should be based on the best available estimate of the number of equity instruments expected to vest. That estimate should be revised if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates.

On the vesting date, the entity should revise the estimate to equal the number of equity instruments that actually vest.

If there is no vesting period, then the equity instruments granted are assumed to be provided in return for services already received and the transaction is recognised in full on the grant date.



### 2.3.3 Example: transactions with employees

Fernando Flowers PLC issues 1,000 share options to each of 300 managers on 1 February 20X1. On this date, the fair value of each option was Rs. 4. The options vest after three years, providing that the individual managers still work for the company. At the 31 January 20X2 year end, the company does not expect any managers to leave.

#### Required

**Prepare** the accounting entry required in respect of the share options in the year ended 31 January 20X2.

**State** how this would change if the share options vested immediately.

#### Solution

- The share options are measured at Rs. 1.2m ( $1,000 \times 300 \times \text{Rs. } 4$ ).
- This is spread equally over each year of the vesting period, giving an expense in the year ended 31 January 20X2 of Rs. 400,000 ( $1.2 \text{ m} / 3 \text{ years}$ ).
- The accounting entry is therefore (Rs):

DEBIT	Staff expenses	400,000
CREDIT	Equity	400,000

- If the options vested immediately, the full Rs. 1.2m would be recognised on the grant date by (Rs):

DEBIT	Staff expenses	400,000
CREDIT	Equity	400,000



### 2.3.4 Example: transactions with employees

On 1 January 20X1 Liyanage Supplies PLC grants 100 share options to each of its 400 employees. Each grant is conditional on the employee working for the entity until 31 December 20X3. The fair value of each share option is Rs. 20.

During 20X1, 20 employees leave and the entity estimates that 20% of the employees will leave during the three-year period.

During 20X2, a further 25 employees leave and the entity now estimates that 25% of its employees will leave during the three-year period.

During 20X3, a further 10 employees leave.

#### Required

**Calculate** the remuneration expense that will be recognised in respect of the share-based payment transaction for each of the three years ended 31 December 20X3.

#### Solution

SLFRS 2 requires Liyanage Supplies to recognise the remuneration expense, based on the fair value of the share options granted, as the services are received during the three-year vesting period.

In 20X1 and 20X2, the entity estimates the number of options expected to vest (by estimating the number of employees likely to leave) and bases the amount that it recognises for the year on this estimate.

In 20X3 it recognises an amount based on the number of options that actually vest. A total of 55 employees left during the three-year period, and therefore 34,500 options  $((400 - 55) \times 100)$  vested.

The amount recognised as an expense for each of the three years is calculated as follows.

		<i>Cumulative expense at year end Rs</i>	<i>Expense for year Rs</i>
20X1	$40,000 \times 80\% \times 20 \times 1/3$	213,333	213,333
20X2	$40,000 \times 75\% \times 20 \times 2/3$	400,000	186,667
20X3	$34,500 \times 20$	690,000	290,000

**QUESTION****Recognition of equity-settled share-based payments 1**

On 1 January 20X3 an entity grants 250 share options to each of its 200 employees. The only condition attached to the grant is that the employees should continue to work for the entity until 31 December 20X6. Five employees leave during the year, which is an average number of leavers.

The market price of each option was Rs. 12 at 1 January 20X3 and Rs. 15 at 31 December 20X3.

**Required**

**Demonstrate** how this transaction will be reflected in the financial statements for the year ended 31 December 20X3.

**ANSWER**

The remuneration expense for the year is based on the fair value of the options granted at the grant date (1 January 20X3). As 5 of the 200 employees left during the year, it is reasonable to assume that 20 employees will leave during the four-year vesting period and that therefore 45,000 options ( $250 \times 180$ ) will actually vest.

Therefore, the entity recognises a remuneration expense of Rs. 135,000 ( $45,000 \times 12 \times \frac{1}{4}$ ) in profit or loss and a corresponding increase in equity of the same amount.

## 2.4 Vesting conditions

Earlier, we defined vesting conditions as the conditions that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement.

These are taken into account when estimating the number of equity instruments that are expected to vest and so measuring equity-settled share based payments.

### 2.4.1 Service and performance conditions

Vesting conditions can be subdivided into service conditions and performance conditions:

- (a) Service conditions require the counterparty to complete a specified period of service (as we have seen in earlier examples).

- (b) Performance conditions require the counterparty to complete a specified period of service and specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time).

Where performance conditions are linked to the share price of an entity, they are known as market conditions and are **not taken into account** when estimating how many shares will vest. Instead, market conditions are taken into account when measuring the fair value of an equity instrument at the grant date.

#### 2.4.2 Non-vesting conditions

Non-vesting conditions are all conditions other than service or performance conditions, eg the requirement that an employee must contribute towards the price of an equity instrument issued.

Non-vesting conditions are taken into account when estimating the fair value of equity instruments granted. They are not, however, taken into account when estimating how many equity instruments will vest for the purposes of measuring equity-settled share-based payments.

### 3 Cash-settled share-based payments



**Cash-settled share-based payments** are recognised as an expense or asset together with a corresponding liability.

#### 3.1 Definition



LKAS 37 defines a **cash-settled share-based payment** as:

A share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity.

A cash-settled share-based payment therefore involves paying the counterparty to the transaction an amount of cash which is determined by reference to share price on a given date.

Examples of this type of transaction include:

- (a) Share appreciation rights granted to employees: the employees become entitled to a future cash payment (rather than an equity instrument), based

on the increase in the entity's share price from a specified level over a specified period of time, or

- (b) A right to receive a future cash payment by granting employees a right to shares that are redeemable.

### 3.2 Measurement of cash-settled share-based payment transactions

The basic principle is that a company measures the goods or services acquired and the liability incurred at the fair value of the liability.

The entity should remeasure the fair value of the liability at each reporting date until the liability is settled and at the date of settlement. Any changes in fair value are recognised in profit or loss for the period.

The entity should recognise the services received, and a liability to pay for those services, as the employees render service. For example, if share appreciation rights do not vest until the employees have completed a specified period of service, the entity should recognise the services received and the related liability, over that period.

As with equity-settled payments, service and non-market performance vesting conditions should be taken into account when estimating the amount of the liability.



#### 3.2.1 Example: cash-settled share-based payment

On 1 January 20X1, Wijekoon Waste PLC grants 100 cash share appreciation rights (SARS) to each of its 500 employees, on condition that the employees continue to work for the entity until 31 December 20X3.

During 20X1, 35 employees leave. The company estimates that a further 60 will leave during 20X2 and 20X3.

During 20X2, 40 employees leave and the company estimates that a further 25 will leave during 20X3.

During 20X3, 22 employees leave.

At 31 December 20X3, 150 employees exercise their SARs. Another 140 employees exercise their SARs at 31 December 20X4 and the remaining 113 employees exercise their SARs at the end of 20X5.

The fair values of the SARs for each year in which a liability exists are shown below, together with the intrinsic values at the dates of exercise.

	<i>Fair value</i>	<i>Intrinsic value</i>
	Rs	Rs
20X1	14.40	
20X2	15.50	
20X3	18.20	15.00
20X4	21.40	20.00
20X5		25.00

**Required**

**Calculate** the amount to be recognised in the profit or loss for each of the five years ended 31 December 20X5 and the liability to be recognised in the statement of financial position at 31 December for each of the five years.

**Solution**

For the three years to the vesting date of 31 December 20X3, the expense is based on the entity's estimate of the number of SARs that will actually vest (as for an equity-settled transaction). However, the fair value of the liability is **remeasured** at each year end.

The intrinsic value of the SARs at the date of exercise is the amount of cash actually paid.

		<i>Liability at year end</i>		<i>Expense for year</i>
		Rs	Rs	Rs
20X1	Expected to vest (500 – 95): $405 \times 100 \times 14.40 \times 1/3$	<u>194,400</u>		194,400
20X2	Expected to vest (500 – 100): $400 \times 100 \times 15.50 \times 2/3$	<u>413,333</u>		218,933
20X3	Exercised: $150 \times 100 \times 15.00$		225,000	
	Not yet exercised (500 – 97 – 150): $253 \times 100 \times 18.20$	<u>460,460</u>	<u>47,127</u>	
				272,127
20X4	Exercised: $140 \times 100 \times 20.00$		280,000	
	Not yet exercised (253 – 140): $113 \times 100 \times 21.40$	<u>241,820</u>	<u>(218,640)</u>	
				61,360
20X5	Exercised: $113 \times 100 \times 25.00$		282,500	
		<u>Nil</u>	<u>(241,820)</u>	
				<u>40,680</u>
				<u>787,500</u>





## QUESTION

## Share-based payments

Gunasekara Imports PLC granted 200 options on its ordinary shares to each of its 800 employees on 1 January 20X1. Each grant is conditional on the employee being employed by the company until 31 December 20X3.

Gunasekara Imports estimated at 1 January 20X1 that:

- (i) The fair value of each option was Rs. 4
- (ii) Approximately 50 employees would leave during 20X1, 40 during 20X2 and 30 during 20X3, thereby forfeiting their rights to receive the options. The departures were expected to be evenly spread within each year.

The exercise price of the options was Rs. 1.50 and the market value of a share on 1 January 20X1 was Rs. 3.

In the event, only 40 employees left during 20X1 (and the estimate of total departures was revised down to 95 at 31 December 20X1), 20 during 20X2 (and the estimate of total departures was revised to 70 at 31 December 20X2) and none during 20X3, spread evenly during each year.

### Required

The directors of Gunasekara Imports have asked you to illustrate how the scheme is accounted for under SLFRS 2 *Share-based payment*.

- (a) **Record** the double entries for the charge to profit or loss for employee services over the three years and for the share issue, assuming all employees entitled to benefit from the scheme exercised their rights and the shares were issued on 31 December 20X3.
- (b) **Explain** how your solution would differ had the company offered its employees cash based on the share value rather than share options.

**ANSWER****(a) Accounting entries**

<i>31.12.X1</i>	Rs
DEBIT Profit or loss (staff costs)	188,000
CREDIT Equity reserve $((800 - 95) \times 200 \times \text{Rs. } 4 \times 1/3)$	188,000

<i>31.12.X2</i>	
DEBIT Profit or loss (staff costs) (W1)	201,333
CREDIT Equity reserve	201,333

<i>31.12.X3</i>	
DEBIT Profit or loss (staff costs) (W2)	202,667
CREDIT Equity reserve	202,667

*Issue of shares:*

DEBIT Cash $(740 \times 200 \times \text{Rs. } 1.50)$	222,000
DEBIT Equity reserve	592,000
CREDIT Stated capital $(740 \times 200 \times \text{Rs. } 1)$	814,000

*Workings***1 Equity reserve at 31.12.X2**

	Rs
Equity b/f	188,000
∴ P/L charge	<u>201,333</u>
Equity c/f $((800 - 70) \times 200 \times \text{Rs. } 4 \times 2/3)$	<u><u>389,333</u></u>

**2 Equity reserve at 31.12.X3**

Equity b/f	389,333
∴ P/L charge	<u>202,667</u>
Equity c/f $((800 - 40 - 20) \times 200 \times \text{Rs. } 4 \times 3/3)$	<u><u>592,000</u></u>

**(b) Cash-settled share-based payment**

If the company had offered cash payments based on the value of the shares at vesting date rather than options, in each of the three years a liability would be shown in the statement of financial position representing the expected amount payable based on the following:

No of employees estimated at the year end to be entitled to rights at the vesting date	×	Number of rights each	×	Fair value of each right at year end	×	Cumulative proportion of vesting period elapsed
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The movement in the liability would be charged to profit or loss representing further entitlements received during the year and adjustments to expectations accrued in previous years.

The liability would continue to be adjusted (resulting in a profit or loss charge) for changes in the fair value of the right over the period between when the rights become fully vested and are subsequently exercised. It would then be reduced for cash payments as the rights are exercised.

## 4 Disclosure of share-based payments



SLFRS 2 requires **extensive disclosures** in respect of share-based payments.

SLFRS 2 requires that information should be disclosed that enables users of the financial statements to:

- (a) Understand the nature and extent of share-based payments that existed during the accounting period.
- (b) Understand how the fair value of the goods or services received or the fair value of the equity instruments granted during the period was determined.
- (c) Understand the effect of share-based payment transactions on a company's profit or loss for a period and its financial position.

### 4.1 Nature and extent of share-based payments

In order to enable users to understand the nature and extent of share-based payments, a company should disclose:

- (a) A description of each type of share-based payment arrangement that existed during the period.
- (b) The number and weighted average exercise prices of share options outstanding at the start of the period, granted during the period, forfeited during the period, exercised during the period, expired during the period, outstanding at the end of the period and exercisable at the end of the period.
- (c) The weighted average share price of share options exercised during the period as at the date of exercise.
- (d) The range of exercise prices and weighted average remaining contractual life for share options outstanding at the end of the period.

## 4.2 Determination of fair value

In order to enable users to understand how fair value was determined, a company should disclose:

- (a) For share options granted during the period, the weighted average fair value of those options at the measurement date and information on how the fair value was measured.
- (b) For other equity instruments granted in the period, the number and weighted average fair value of those instruments at the measurement date and information on how fair value was measured.
- (c) Details of share-based payment arrangements that were modified during the period.

## 4.3 Effect of share-based payments

In order to enable users to understand the effect of share-based payments on performance and position, a company should disclose:

- (a) The total expense recognised in the period in respect of share-based payment transactions
- (b) For liabilities arising from share-based payment transactions:
  - (i) The total carrying amount at the end of the period
  - (ii) The total intrinsic value at the end of the period of liabilities for which the right to cash had vested



## CHAPTER ROUNDUP

- ↪ **SLFRS 2** requires that share-based payment transactions are recognised in profit or loss in order to be consistent with the recognition of similar transactions for cash.
- ↪ **Equity-settled share-based payments** are recognised as an expense or asset with a corresponding increase to equity.
- ↪ **Cash-settled share-based payments** are recognised as an expense or asset together with a corresponding liability.
- ↪ SLFRS 2 requires **extensive disclosures** in respect of share-based payments.



# PROGRESS TEST

- 1 What is a cash-settled share based payment transaction?
- 2 What is the grant date?
- 3 If an entity has entered into an equity settled share-based payment transaction, what should it recognise in its financial statements?
- 4 Where an entity has granted share options to its employees in return for services, how is the transaction measured?
- 5 During its financial year ended 31 January 20X6, Adikari Dias PLC issued share options to several of its senior employees. The options vest immediately on issue.  
Which **one** of the following describes the accounting entry that is required to recognise the options?
 

A	DEBIT retained earnings	CREDIT liabilities
B	DEBIT retained earnings	CREDIT equity
C	DEBIT profit or loss	CREDIT liabilities
D	DEBIT profit or loss	CREDIT equity
- 6 Which of the following are not taken into account when determining how many equity instruments will vest?
  - 1 Market-based performance conditions
  - 2 Service conditions
  - 3 Non-vesting conditions
  - 4 Non-market based performance conditions

A	1 and 2
B	3 and 4
C	1 and 3
D	2 and 4
- 7 A company issued 25 key members of staff with 1,000 share options each on 1 August 20X4. On this date, the fair value of each option was Rs. 6. The staff members will become entitled to the options if they remain in the employment of the company on 31 July 20X6. At 1 August 20X4, it is expected that all members of staff will remain; at 31 July 20X5, it is expected that two will have left by 31 July 20X6. What expense is recognised in the year ended 31 July 20X5?
 

A	Rs. 69,000
B	Rs. 75,000
C	Rs. 138,000
D	Rs. 150,000

## ANSWERS TO PROGRESS TEST

- 1 A transaction in which the entity receives goods or services in exchange for amounts of cash that are based on the price (or value) of the entity's shares or other equity instruments of the entity.
- 2 The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the other party have a shared understanding of the terms and conditions of the arrangement.
- 3 The goods or services received and a corresponding increase in equity.
- 4 By reference to the fair value of the equity instruments granted, measured at grant date.
- 5 The answer is **D**. Under SLFRS 2, an expense is recognised in profit or loss and in the case of an equity-settled share-based payment, a credit is made to equity.
- 6 The answer is **C**. Non-vesting conditions and market-based performance conditions affect the valuation of the equity instrument at the grant date but not measurement of the equity instruments expected to vest.
- 7 The answer is **A**. The number of share options expected to vest is 23,000 ( $1,000 \times (25 - 2)$ ). These are measured at Rs. 6 each and half of the expected expense is recognised in the year ended 31 July 20X5, ie  $(23,000 \times 6)/2 = \text{Rs. } 69,000$ .





# Part C - Financial reporting standards: disclosure



# Assets Held for Sale and Discontinued Operations

## INTRODUCTION

**SLFRS 5** on assets held for sale and discontinued operations is an important standard which gives users additional information that is useful in predicting future performance. Assets held for sale will be sold in the short term and so no longer contribute towards revenue generation; the results of discontinued operations will not contribute to a company's performance in future years.

### Knowledge Component

#### 2 Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)

2.2	Level B	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.

**CHAPTER CONTENTS**

- 1 Assets held for sale
- 2 Discontinued operations

**LEARNING  
OUTCOME**

2.2  
2.2

**SLFRS 5 Learning objectives**

- Discuss the classification of non-current assets held for sale or as held for distribution to owners.
- Explain measurement of non-current assets classified as held for sale.
- Compute the value of non-current assets held for sale.
- Assess impairment losses on non-current assets held for sale.
- Outline the disclosures to be made in respect of non-current assets held for sale and discontinued operations.
- Apply the methodology to the classification of non-current assets as held for sale or as held for distribution to owners.

**1 Assets held for sale**

**SLFRS 5 requires assets 'held for sale' to be presented separately in the statement of financial position.**

SLFRS 5 requires that:

- Assets and groups of assets that are 'held for sale' or 'held for distribution to owners' are presented separately in the statement of financial position
- The results of discontinued operations are presented separately in the statement of profit or loss and other comprehensive income

This is required so that users of financial statements will be better able to make projections about the financial position, profits and cash flows of the entity. If an asset (or group of assets) is to be sold or distributed to owners, then it will not contribute to future revenues; equally if part of a business is to be discontinued, then its results will not contribute to overall results in the future. By reporting these amounts separately, SLFRS 5 provides users of financial statements with better and more relevant information for decision-making purposes.

In this section of the chapter, we concentrate on the statement of financial position and assets held for sale or held for distribution to owners; in the next section, we shall think about the statement of profit or loss and discontinued operations.

## **1.1 Classification of assets as held for sale or held for distribution**

SLFRS 5 introduces strict criteria in order to classify an asset as held for sale or for distribution.

### **1.1.1 Assets held for sale**

A non-current asset is classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. For this to be the case:

- (a) The asset must be available for immediate sale in its present condition.
- (b) Its sale must be highly probable.

For the sale to be highly probable, the following must apply.

- Management must be committed to a plan to sell the asset.
- There must be an active programme to locate a buyer.
- The asset must be marketed for sale at a price that is reasonable in relation to its current fair value.
- The sale should be expected to take place within one year from the date of classification.
- It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

An asset can still be classified as held for sale, even if the sale has not actually taken place within one year. However, the delay must have been caused by events or circumstances beyond the entity's control and there must be sufficient evidence that the entity is still committed to sell the asset. Otherwise the entity must cease to classify the asset as held for sale.

If an entity acquires an asset exclusively with a view to its subsequent disposal, it can classify the asset as held for sale only if the sale is expected to take place within one year and it is highly probable that all the other criteria will be met within a short time (normally three months).

### 1.1.2 Classification of assets as held for distribution

A non-current asset is classified as held for distribution to owners when an entity is committed to distribute the asset to the owners. For this to be the case:

- (a) The asset must be available for distribution in its present condition.
- (b) The distribution must be highly probable.

For the distribution to be highly probable:

- Actions to complete the distribution must have been initiated.
- The distribution should be expected to be completed within one year of the date of classification.
- It is unlikely that significant changes to the plan will be made or the distribution will be withdrawn.

An assessment of whether a distribution is 'highly probable' should also include consideration of the probability of shareholder approval (if required).

### 1.1.3 Assets that are to be abandoned

A non-current asset that is to be abandoned may not be classified as held for sale, as its carrying amount will be recovered principally through continuing use. A non-current asset that is to be used to the end of its economic life is an example of an asset that is to be abandoned.

## 1.2 Disposal groups

In the previous section we referred to individual assets held for sale or held for distribution. SLFRS 5 and the classification rules above are also relevant to groups of assets, known as 'disposal groups' and defined as follows.



**A disposal group** is a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction.

In practice, a disposal group could be a subsidiary, an LKAS 36 cash-generating unit or a single operation within an entity.

**QUESTION****Classification as held for sale**

- (1) On 1 December 20X3, a company became committed to a plan to sell a manufacturing facility and has already found a potential buyer. The company does not intend to discontinue the operations currently carried out in the facility. At 31 December 20X3 there is a backlog of uncompleted customer orders. The company will not be able to transfer the facility to the buyer until after it ceases to operate the facility and has eliminated the backlog of uncompleted customer orders. This is not expected to occur until Spring 20X4.
- (2) Badulla Industries PLC is committed to a plan to sell its head office building, and at 31 December 20X3 has engaged the services of an agent to locate a buyer. Badulla Industries is having a new head office constructed and will use the existing building until the completion of its new premises. When Badulla Industries vacates the property, the existing head office will be transferred to a buyer.

**Required**

**Assess** whether the manufacturing facility and head office can be classified as 'held for sale' at 31 December 20X3.

**ANSWER**

- (1) The facility will not be transferred until the backlog of orders is completed; this demonstrates that the facility is not available for immediate sale in its present condition. The facility cannot be classified as 'held for sale' at 31 December 20X3. It must be treated in the same way as other items of property, plant and equipment: it should continue to be depreciated and should not be separately disclosed.
- (2) The head office should not be classified as held for sale; the delay in transferring the property to a buyer demonstrates that it is not available for immediate sale.

**1.3 Measurement of assets held for sale**

The measurement requirements of SLFRS 5 are relevant to assets and disposal groups held for sale or held for distribution to owners.

### 1.3.1 Scoped out assets

A number of assets are scoped out of the SLFRS 5 measurement requirements. These assets are subject to the classification and presentation requirements of SLFRS 5; however they continue to be measured in accordance with the relevant standard.

- (a) Deferred tax assets (LKAS 12)
- (b) Assets arising from employee benefits (LKAS 19)
- (c) Financial assets (LKAS 39/SLFRS 9)
- (d) Investment properties accounted for in accordance with the fair value model (LKAS 40)
- (e) Agricultural and biological assets (LKAS 41)
- (f) Insurance contracts (SLFRS 4)

### 1.3.2 Initial measurement requirements

Immediately prior to classification as held for sale or distribution, the carrying amount of an asset (or the assets and liabilities of a disposal group) is measured according to the previously applicable accounting standard.

On transfer to the held for sale category, a non-current asset or disposal group is measured at the lower of its carrying amount and fair value less costs to sell.

On transfer to the held for distribution category, a non-current asset or disposal group classified is measured at the lower of its carrying amount and fair value less costs to distribute.

The following definitions provided in SLFRS 5 are relevant to measurement.



**Fair value:** the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (SLFRS 13).

**Costs to sell:** the incremental costs directly attributable to the disposal of an asset (or disposal group), excluding finance costs and income tax expense.

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These requirements will normally result in a newly acquired asset that is immediately classified as held for sale being measured at fair value (in this case, likely to be equal to carrying amount of cost) less costs to sell.



### 1.3.3 Impairment losses

An impairment loss should be recognised where the fair value less costs to sell is lower than carrying amount at the point of transfer to held for sale. This is charged to profit or loss.

An impairment loss recognised on a disposal group is allocated to the non-current assets of the disposal group that are within the measurement requirements of SLFRS 5 in the following order:

- (a) To reduce the carrying amount of any goodwill
- (b) Then, to the other assets of the disposal group on a pro-rata basis related to carrying amounts

### 1.3.4 Subsequent measurement

Non-current assets held for sale should not be depreciated, even if they are still being used by the entity.



#### QUESTION

#### Measurement of asset held for sale

Aptus Manufacturing PLC has owned a packaging machine for a number of years. The machine cost Rs. 1 and has a carrying amount of Rs. 800,000 at 1 January 20X3 with a remaining useful life of eight years. On 1 July 20X3, the management of Aptus Manufacturing decided to sell the machine and immediately advertised it as being for sale in relevant trade publications. The market value of the machine at 1 July 20X3 is Rs. 760,000 and Aptus Manufacturing has agreed to transport the machine to the purchaser at a cost of Rs. 20,000. At the year end of 31 December 20X3, the machine remains unsold although the criteria to classify it as held for sale are still met. At this date, the market value of the machine is unchanged at Rs. 760,000.

#### Required

**Calculate** the value at which the machine should be included in the statement of financial position at 31 December 20X3 and **record** the amounts recognised in profit or loss during the year in respect of the machine.

#### ANSWER

At 1 July 20X3 the machine is classified as held for sale. At this date it is measured at the lower of carrying amount and fair value less costs to sell.

- Carrying amount is Rs. 750,000 (Rs. 800,000 × 90/96 months)
- Fair value less costs to sell is Rs. 740,000 (Rs. 760,000 – Rs. 20,000)

Therefore, the asset is initially recognised as an asset held for sale at Rs. 740,000 and an impairment loss of Rs. 10,000 is recognised in profit or loss.

The asset is no longer depreciated.

### **Summary – amounts recognised in financial statements**

#### *Statement of financial position at 31 December 20X3*

Non-current asset held for sale	Rs. 740,000
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#### *Statement of profit or loss for the year ended 31 December 20X3*

Depreciation (Rs. 800,000/8 × 6/12m)	Rs. 50,000
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Impairment loss on transfer to AHFS	Rs. 10,000
-------------------------------------	------------

## **1.4 Presentation of assets and disposal groups held for sale**

Non-current assets and the assets of disposal groups classified as held for sale or distribution should be presented separately from other assets in the statement of financial position.

The liabilities of a disposal group classified as held for sale should be presented separately from other liabilities in the statement of financial position.

- (a) Assets and liabilities held for sale/distribution should not be offset and presented as a single amount.
- (b) The major classes of assets and liabilities held for sale should be separately disclosed either on the face of the statement of financial position or in the notes, unless a disposal group is a newly acquired subsidiary.
- (c) SLFRS 5 requires non-current assets or disposal groups held for sale to be shown as a separate component of current assets/current liabilities.

Note that assets held for sale and the assets and liabilities of disposal groups are not reclassified in the comparative statement of financial position presented within a set of financial statements.

## **1.5 Additional disclosures**

The following should be disclosed in the notes to the financial statements in the period in which a non-current asset or disposal group has been classified as held for sale or sold.

- (a) A description of the non-current asset or disposal group
- (b) A description of the facts and circumstances of the sale or leading to the expected disposal and the expected timing and manner of disposal

- (c) The loss recognised on transfer to held for sale and the caption in the statement of comprehensive income that includes that amount
- (d) If applicable, the reporting segment in which the asset or disposal group is presented in accordance with SLFRS 8 *Operating segments*

## 2 Discontinued operations



**SLFRS 5 defines discontinued operations and sets out the required disclosures in respect of such operations.**

### 2.1 Definition



**A discontinued operation** is a component of an entity that has either been disposed of, or is classified as held for sale, and:

- (a) Represents a separate major line of business or geographical area of operations
- (b) Is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations, or
- (c) Is a subsidiary acquired exclusively with a view to resale

A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

### 2.2 Presentation of discontinued operations

An entity should present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations.

This allows users to distinguish between operations which will continue in the future and those which will not, and makes it more possible to predict future results.

#### 2.2.1 Statement of comprehensive income

An entity should disclose a single amount in the statement of comprehensive income comprising the total of:

- (a) The post-tax profit or loss of discontinued operations
- (b) The post-tax gain or loss recognised on the measurement to fair value less costs of disposal or on the disposal of the assets or disposal group(s) constituting the discontinued operation

An entity should also disclose an analysis of this single amount into:

- (a) The revenue, expenses and pre-tax profit or loss of discontinued operations
- (b) The related income tax expense
- (c) The gain or loss recognised on the measurement to fair value less costs of disposal or on the disposal of the assets of the discontinued operation
- (d) The related income tax expense

This may be presented either in the statement of comprehensive income or in the notes. If it is presented in the statement of comprehensive income, it should be presented in a section identified as relating to discontinued operations, ie separately from continuing operations. Gains and losses on the remeasurement of a disposal group that is not a discontinued operation but is held for sale should be included in profit or loss from continuing operations.

This analysis is not required where the discontinued operation is a newly acquired subsidiary that has been classified as held for sale.

### **2.2.2 Statement of cash flows**

An entity should disclose the net cash flows attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either on the face of the statement of cash flows or in the notes.

Again, this analysis is not required where the discontinued operation is a newly acquired subsidiary that has been classified as held for sale.

## **2.3 Illustration**

The following illustration is taken from the implementation guidance to SLFRS 5. Profit for the period from discontinued operations would be analysed in the notes.

## XYZ GROUP

## STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X2

	20X2	20X1
	Rs'000	Rs'000
<b>Continuing operations</b>		
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year from continuing operations	<u>X</u>	<u>X</u>
<b>Discontinued operations</b>		
Profit for the year from discontinued operations	<u>X</u>	<u>X</u>
Profit for the year	<u><u>X</u></u>	<u><u>X</u></u>
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interest	<u>X</u>	<u>X</u>
	<u><u>X</u></u>	<u><u>X</u></u>

Note that if there were items of 'other comprehensive income', this would be shown as a full 'statement of comprehensive income'.

**QUESTION****Discontinued operations**

On 20 October 20X3, the directors of a parent company made a public announcement of plans to close a steel works. The closure means that the group will no longer carry out this type of operation, which until recently has represented about 10% of its total revenue. The works will be gradually shut down over a period of several months, with complete closure expected in July 20X4. At 31 December, output had been significantly reduced and some redundancies had already taken place. The cash flows, revenues and expenses relating to the steel works can be clearly distinguished from those of the subsidiary's other operations.

**Required**

**Explain** how the closure should be treated in the financial statements for the year ended 31 December 20X3.

**ANSWER**

Because the steel works is being closed, rather than sold, it cannot be classified as 'held for sale'. In addition, the steel works is not a discontinued operation. Although at 31 December 20X3 the group was firmly committed to the closure, this has not yet taken place nor can its assets be classified as held for sale, therefore the steel works must be included in continuing operations. Information about the planned closure could be disclosed in the notes to the financial statements.

**CHAPTER ROUNDUP**

- ↳ **SLFRS 5 requires assets 'held for sale' to be presented separately in the statement of financial position.**
- ↳ **SLFRS 5 defines discontinued operations and sets out the required disclosures in respect of such operations.**


**PROGRESS TEST**

- 1 When can a non-current asset be classified as held for sale?
- 2 How should an asset held for sale be measured?
- 3 Name three assets which may be classified as held for sale but are not measured in accordance with SLFRS 5.
- 4 How does SLFRS 5 define a discontinued operation?
- 5 What amount must be disclosed on the face of the statement of comprehensive income in respect of discontinued operations?
- 6 Which of the following statements is/are true?
  - 1 A non-current asset that will be used to the end of its economic life may meet the conditions to be classified as held for sale.
  - 2 A disposal group may be an LKAS 36 cash-generating unit.
  - A 1 only
  - B 2 only
  - C Neither of them
  - D Both of them
- 7 A company operates in the power generation sector and is committed to a plan to sell part of its operations. The sale requires regulatory approval which could extend the period to complete the sale beyond one year since actions to obtain the approval cannot commence until a buyer is identified. It is highly probable that a buyer will be identified within 12 months.  
Can the operations be classified as a disposal group held for sale?
  - A Yes
  - B No
- 8 On 1 March 20X4, a subsidiary of Dambulla Trading PLC meets the criteria to be classified as held for sale. At this date, the subsidiary has a carrying amount of Rs. 90m and its fair value is Rs. 120m. Costs to sell are expected to amount to Rs. 10m. The subsidiary makes a post-tax loss of Rs. 6m in the year ended 31 December 20X4, Rs. 5m of which arose after classification as held for sale. What single amount must be disclosed in the statement of comprehensive income in respect of the subsidiary, assuming that it is a discontinued operation?
  - A Rs. 5m loss
  - B Rs. 6m loss
  - C Rs. 25m loss
  - D Rs. 26m loss



## ANSWERS TO PROGRESS TEST

- 1 (a) The asset must be available for immediate sale in its present condition  
(b) Its sale must be highly probable (ie significantly more likely than not)
- 2 At the lower of carrying amount and fair value less costs of sale
- 3 Deferred tax assets (LKAS 12), assets arising from employee benefits (LKAS 19), financial assets (LKAS 39/SLFRS 9), investment properties measured at fair value (LKAS 40), agricultural and biological assets measured at fair value less costs to sell (LKAS 40) and insurance contracts (SLFRS 4).
- 4 Refer to Section 2.1.
- 5 A single amount comprising the post-tax profit or loss of discontinued operations and the post-tax gain or loss on measurement of the discontinued operation (disposal group) to fair value less costs to sell.
- 6 The answer is **B**. 1 describes an asset that is to be abandoned; this cannot be classified as held for sale.
- 7 The answer is **A**. The delay is caused by events or circumstances beyond the entity's control and there is sufficient evidence that the entity is still committed to sell the asset.
- 8 The answer is **D**. The single amount disclosed in the statement of comprehensive income should comprise:
  - 1 The post-tax loss of the subsidiary for the full year (Rs. 6m)
  - 2 The loss recognised on remeasurement to fair value less costs to sell (Rs. 20m)



# Related Party Transactions

## INTRODUCTION

LKAS 24 *Related party disclosures* is, as the name suggests, a disclosure standard. It is concerned with highlighting any transactions that an entity may have entered into with parties that are related.

### Knowledge Component

#### 2 Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)

2.2	Level B	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.

**CHAPTER CONTENTS**

- 1 Introduction and purpose
- 2 Definitions
- 3 Disclosures

**LEARNING  
OUTCOME**

- 2.2
- 2.2
- 2.2

**LKAS 24 Learning objectives**

- Define a related party.
- Apply the requirements provided in the standard to identify related parties and related party transactions.
- Prepare the disclosure requirements with regard to related parties, as per the standard.

**1 Introduction and purpose**

**LKAS 24** is primarily a disclosure standard. It is concerned to improve the quality of information provided by published accounts and also to strengthen their stewardship roles.

In the absence of information to the contrary, it is assumed that a reporting entity pursues its activities independently of the interests of its individual owners, managers and others. Transactions are presumed to have been undertaken on an arm's length basis, ie on terms such as could have been obtained in a transaction with an external party, in which each side bargained knowledgeably and freely, unaffected by any relationship between them.

These assumptions may not be justified when related party relationships exist; while the parties may endeavour to achieve arm's length bargaining, the very nature of the relationship may preclude this occurring.

**1.1 Objective of LKAS 24**

LKAS 24 tackles the issue of related parties by ensuring that financial statements contain the disclosures necessary to draw attention to the possibility that the reported financial position and results may have been affected by the existence of

related parties and by material transactions with them. In other words, this is a standard that is primarily concerned with **disclosure**.

## 1.2 Scope

The standard requires disclosure of related party transactions and outstanding balances in the separate financial statements of a parent, venturer or investor presented in accordance with LKAS 27 as well as in consolidated financial statements.

An entity's financial statements disclose related party transactions and outstanding balances with other entities in a group. Intra-group transactions and balances are eliminated in the preparation of consolidated financial statements.

## 2 Definitions



**The definition of a related party is crucial to the application of LKAS 24.**

The following important definitions are given by the standard. Note that the definitions of control and significant influence are the same as those given in SLFRS 10, LKAS 28 and SLFRS 11.



**Related party.** A related party is a person or entity that is related to the entity that is preparing its financial statements.

- (a) A person or a close member of that person's family is related to a reporting entity if that person:
  - (i) Has control or joint control over the reporting entity
  - (ii) Has significant influence over the reporting entity
  - (iii) Is a member of the key management personnel of the reporting entity or of a parent of the reporting entity
- (b) An entity is related to a reporting entity if any of the following conditions applies:
  - (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).
  - (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
  - (iii) Both entities are joint ventures of the same third party.

- (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
- (v) The entity is a post-employment defined benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
- (vi) The entity is controlled or jointly controlled by a person identified in (a).
- (vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

**Related party transaction.** A transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

**Control** is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

**Significant influence** is the power to participate in the financial and operating policy decisions of an entity, but is not control over these policies. Significant ownership may be gained by share ownership, statute or agreement.

**Joint control** is the contractually agreed sharing of control over an economic activity.

**Key management personnel** are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

**Close members of the family of an individual** are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity. They may include:

- (a) The individual's domestic partner and children
- (b) Children of the domestic partner
- (c) Dependants of the individual or the domestic partner

## 2.1 Application of the definition

When considering each possible related party relationship, attention must be paid to the substance of the relationship, not merely the legal form.

LKAS 24 lists the following, which are not necessarily related parties.

- (a) Two entities simply because they have a director or other key management in common (notwithstanding the definition of related party above, although it is necessary to consider how that director would affect both entities)
- (b) Two venturers, simply because they share joint control over a joint venture
- (c) Certain other bodies, simply as a result of their role in normal business dealings with the entity:
  - (i) Providers of finance
  - (ii) Trade unions
  - (iii) Public utilities
  - (iv) Government departments and agencies
- (d) Any single customer, supplier, franchisor, distributor, or general agent with whom the entity transacts a significant amount of business, simply by virtue of the resulting economic dependence

## 2.2 Related party transactions

The standard lists some examples of transactions that are disclosed if they are with a related party:

- Purchases or sales of goods (finished or unfinished)
- Purchases or sales of property and other assets
- Rendering or receiving of services
- Leases
- Transfer of research and development
- Transfers under licence agreements
- Provision of finance (including loans and equity contributions in cash or in kind)
- Provision of guarantees and collateral security
- Settlement of liabilities on behalf of the entity or by the entity on behalf of another party

### 3 Disclosures



**LKAS 24 requires extensive disclosures of related parties and transactions with them.**

As noted above, LKAS 24 is almost entirely concerned with disclosure, and its provisions are meant to supplement those disclosure requirements required by national company legislation and other SLFRSs (particularly LKAS 1, SLFRS 10, SLFRS 11 and SLFRS 12).

Disclosure is required in respect of the controlling party and parent-subsidary relationships, transactions with key management personnel and other related party transactions.

#### 3.1 Controlling party disclosures

Relationships between parents and subsidiaries must be disclosed irrespective of whether any transactions have taken place between the related parties. An entity must disclose the name of its parent and, if different, the ultimate controlling party. This will enable a reader of the financial statements to be able to form a view about the effects of a related party relationship on the reporting entity.

If neither the parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so shall also be disclosed.

#### 3.2 Key management personnel disclosures

An entity should disclose key management personnel compensation in total and for each of the following categories:

- (a) Short-term employee benefits
- (b) Post-employment benefits
- (c) Other long-term benefits
- (d) Termination benefits
- (e) Share-based payment

#### 3.3 Other related party transaction disclosures

If there are transactions between related parties, the nature of the related party relationship should be disclosed as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the



relationship on the financial statements. At a minimum, disclosures should include:

- (a) The amount of transactions
- (b) The amount of outstanding balances and their terms and conditions and details of guarantees given or received
- (c) Provisions for doubtful debts related to outstanding balances
- (d) The expense recognised in the period in respect of bad or doubtful debts due from related parties

These disclosures should be made separately for each of the following categories:

- The parent
- Entities with joint control/significant influence over the entity
- Subsidiaries
- Associates
- Joint ventures in which the entity is a venture
- Key management personnel of the entity or its parent, and other related parties

Items of a similar nature may be disclosed in aggregate **unless** separate disclosure is necessary for an understanding of the effect on the financial statements.

Disclosures that related party transactions were made on terms equivalent to those that prevail in arm's length transactions are made only if such disclosures can be substantiated.



## QUESTION

## Related party transactions

**Discuss** whether the following events would require disclosure in the financial statements of the RP Group, a listed company, under LKAS 24 *Related party disclosures*.

The RP Group, merchant bankers, has a number of subsidiaries, associates and joint ventures in its group structure. During the financial year to 31 October 20X9, the following events occurred.

- (a) The company agreed to finance a management buyout of a group company, AB, a limited company. In addition to providing loan finance, the company has retained a 25% equity holding in the company and has a main board director on the board of AB. RP received management fees, interest payments and dividends from AB.
- (b) On 1 July 20X9, RP sold a wholly owned subsidiary, X, a limited company, to Z, a public limited company. During the year, RP supplied X with secondhand office equipment and X leased its factory from RP. The transactions were all contracted for at market rates.

- (c) The retirement benefit scheme of the group is managed by another merchant bank. An investment manager of the group retirement benefit scheme is also a non-executive director of the RP Group and received an annual fee for his services of Rs. 250,000 which is not material in the group context. The company pays Rs. 16m per annum into the scheme and occasionally transfers assets into the scheme. In 20X9, property, plant and equipment of Rs. 10m were transferred into the scheme and a recharge of administrative costs of Rs. 3m was made.

## ANSWER

- (a) LKAS 24 does not require disclosure of transactions between companies and providers of finance in the ordinary course of business. As RP is a merchant bank, no disclosure is needed between RP and AB. However, RP owns 25% of the equity of AB and it would seem significant influence exists (LKAS 28, greater than 20% existing holding means significant influence is presumed) and therefore AB could be an associate of RP. LKAS 24 regards associates as related parties.

The decision as to associate status depends on the ability of RP to exercise significant influence especially as the other 75% of votes are owned by the management of AB.

Merchant banks tend to regard companies that would qualify for associate status as trade investments, since the relationship is designed to provide finance.

LKAS 28 presumes that a party owning or able to exercise control over 20% of voting rights is a related party. So an investor with a 25% holding and a director on the board would be expected to have significant influence over operating and financial policies in such a way as to inhibit the pursuit of separate interests. If it can be shown that this is not the case, there is no related party relationship.

If it is decided that there is a related party situation, then all material transactions should be disclosed including management fees, interest, dividends and the terms of the loan.

- (b) LKAS 24 does **not** require intra-group transactions and balances eliminated on consolidation to be disclosed. LKAS 24 does not deal with the situation where an undertaking becomes, or ceases to be, a subsidiary during the year. Best practice indicates that related party transactions should be disclosed for the period when X was not part of the group. Transactions between RP and X should be disclosed between 1 July 20X9 and 31 October 20X9, but transactions prior to 1 July will have been eliminated on consolidation.

There is no related party relationship between RP and Z, since it is a normal business transaction unless either party's interests have been influenced or controlled in some way by the other party.

- (c) Employee retirement benefit schemes of the reporting entity are included in the LKAS 24 definition of related parties.

The contributions paid, the non-current asset transfer (Rs. 10m) and the charge of administrative costs (Rs. 3m) must be disclosed.

The pension investment manager would not normally be considered a related party. However, the manager is key management personnel by virtue of his non-executive directorship.

Directors are deemed to be related parties by LKAS 24, and the manager receives a Rs. 250,000 fee. LKAS 24 requires the disclosure of compensation paid to key management personnel and the fee falls within the definition of compensation. Therefore, it must be disclosed.



## QUESTION

## Related party disclosure

The following information relates to the Colombo Group companies and transactions with other parties:

- Mrs C, a director of Kandy, a 90% subsidiary of Colombo, has borrowed Rs. 1,000,000 from Colombo.
- Mrs B, one of the directors of Colombo, is paid by Moratuwa, a 75% subsidiary, to act as an independent consultant. She is paid an annual sum of Rs. 400,000.
- Galle, a company controlled by the brother of a director of Colombo, is a customer of Kandy. During the year ended 31 December 2010, Galle purchased Rs. 100,000 goods from Kandy; at the year end, Rs. 60,000 is outstanding. Rs. 10,000 of this amount is six months overdue and the directors of Kandy have decided to provide for this amount in full.
- Kandy has provided a bank guarantee to its main customer in order to ensure continuing trading.

- Directors of group companies are remunerated as follows:

	<i>Salary Rs</i>	<i>Bonus Rs</i>	<i>Pension Rs</i>
<b>Colombo</b>			
Mr A	1,200,000	300,000	500,000
Mrs B	780,000	260,000	500,000
<b>Kandy</b>			
Mrs C	890,000	400,000	440,000
Mrs D	880,000	380,000	530,000
<b>Moratuwa</b>			
Mr E	820,000	370,000	420,000
Mr F	790,000	370,000	420,000

### Required

**Prepare** the related party disclosure note for the Colombo Group financial statements for the year ended 31 December 20X4.

## ANSWER

### Identification of related parties

- Colombo, Kandy and Moratuwa are related to each other as group companies.
- The three companies are also related to Galle (assuming that the brother is a close family member of the director of Colombo).
- Colombo is related to Mr A and Mrs B.
- Kandy is related to Mr A, Mrs B, Mrs C and Mrs D.
- Moratuwa is related to Mr A, Mrs B, Mr E and Mr F.
- Kandy is not related to its main customer simply by virtue of economic dependence.

### Related party transactions

- The loan from Colombo to Mrs C is not a related party transaction, as Mrs C can not influence Colombo.
- Mrs B's work as independent consultant for Moratuwa is a related party transaction.
- The transactions between Kandy and Galle are related party transactions.
- The bank guarantee is not a related party transaction.

### Related parties disclosure note

The Colombo Group includes the following companies.

Colombo	
Kandy	90% owned by Colombo
Moratuwa	75% owned by Kandy

Balances and transactions between Colombo and its subsidiaries, which are related parties, have been eliminated on consolidation and are not disclosed in this note.

### Trading transactions

During the year, group companies entered into the following transactions with related parties that are not members of the group.

	Rs
Sale of goods to other related parties	1,500,000
Receipt of services from key management personnel other than in their capacity as key management personnel	400,000

The following amounts were outstanding at the reporting date.

	Rs
Other related parties	600,000
Less provision for doubtful debt	<u>(100,000)</u>
	500,000

### Compensation of key management personnel

The compensation of the directors, who are the key management personnel of the group, is set out below in aggregate for each of the categories specified in LKAS 24 *Related party disclosures*.

	Rs'000
Short-term employee benefits	2,540
Post-employment benefits	<u>1,000</u>
	<u>2,540</u>

**CHAPTER ROUNDUP**

- ↳ **LKAS 24 is primarily a disclosure standard. It is concerned to improve the quality of information provided by published accounts and also to strengthen their stewardship roles.**
- ↳ **The definition of a related party is crucial to the application of LKAS 24.**
- ↳ **LKAS 24 requires extensive disclosures of related parties and transactions with them.**


**PROGRESS TEST**

- 1 Is a managing director of a company a related party?
- 2 Is the wife of the 100% shareholder of a company a related party?
- 3 The part-time sales director of ABC Co is also a part-time director of XYZ Co. Are the two companies related?
- 4 Weerakoon Water PLC has a 75% investment in Weeraquatics Ltd, which in turn has a 60% investment in West Water Ltd. Mia Perera is the sales director of Weerakoon Water PLC, and her husband is the chief operating officer of Hippala Homes PLC. To which companies is she related?
  - A Weerakoon Water PLC
  - B Weerakoon Water PLC and Hippala Homes PLC
  - C Weerakoon Water PLC, Hippala Homes PLC and Weeraquatics Ltd
  - D All of the companies
- 5 Which of the following statements is/are true?
  - 1 Relationships between parents and subsidiaries must be disclosed, irrespective of whether any transactions have taken place between the related parties.
  - 2 If the managing director of one company owns 75% shares in another company, the two companies are related.
  - A 1 only
  - B 2 only
  - C 1 and 2
  - D Neither 1 nor 2
- 6 AB is an 80% owned subsidiary of TD. The directors of AB are Mr Singh and Mrs Chandala.  
Which of the following is not a related party of AB?
  - A A company that Mrs Chandala and her sister jointly control
  - B A director of TD
  - C PS, a 90% owned subsidiary of TD
  - D Mr Silva, a director of TD

## ANSWERS TO PROGRESS TEST

- 1 Yes. See (a)(iii) within the definition of a related party in Section 2.
- 2 Yes. The husband is a related party by virtue of (a)(i) of the definition of a related party (Section 2); the wife is therefore a related party, as she is a close family member of her husband.
- 3 The sales director is related to ABC Co by virtue of (a)(iii) of the definition (Section 2); he is also related to XYZ Co by virtue of (a)(iii) of the definition. ABC Co and XYZ Co are not necessarily related to each other simply because of this fact; however, the substance of the relationship may be that they are related.
- 4 The answer is **D**. She is related to Weerakoon Water and its subsidiaries (including the sub-subsidiary) by virtue of (a)(iii) of the definition in Section 2, and to Hippala Homes by virtue of the fact that she is a close family member of that company's chief operating officer.
- 5 The answer is **C**. The two companies are related by virtue of (b)(vi) of the definition of a related party.
- 6 The answer is **D**.  
 A – The company is related to AB by virtue of (b)(vi) of the definition.  
 B – The director of TD is related to AB by virtue of (a)(iii) of the definition.  
 C – PS is related to AB by virtue of (b)(i) of the definition.



# Operating Segments

## INTRODUCTION

SLFRS 8 *Operating segments* requires some entities to disclose the results of operating segments. This allows users to gain a greater understanding of the position and performance of the entity more thoroughly.

Knowledge Component			
<b>2</b>	<b>Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)</b>		
<b>2.3</b>	<b>Level C</b>	2.3.1	Explain the concepts/principles of Sri Lanka Accounting Standards.
		2.3.2	Apply the concepts/principles of the standards to resolve a simple/straightforward matter.
		2.3.3	List the disclosures to be made in the financial statements.

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1 Introduction	2.3
2 Operating segments	2.3
3 Reportable segments	2.3
4 Disclosure	2.3

**SLFRS 8 Learning objectives**

- Describe operating segments.
- List the quantitative thresholds an entity shall report about an operating segment.
- Apply the methodology to identify operating segments.
- List the disclosure requirements with regard to operating segments as per the standard.

**1 Introduction**

An important aspect of reporting financial performance is **segment reporting**. This is covered by SLFRS 8 *Operating segments*.

Large entities produce a wide range of products and services, often in several different countries. Further information on how the overall results of entities are made up from each of these product or geographical areas will help the users of the financial statements. This is the reason for **segment reporting**.

- The entity's **past performance** will be better understood
- The entity's **risks and returns** may be better assessed
- More **informed judgements** may be made about the entity as a whole

Risks and returns of a **diversified, multi-national company** can only be assessed by looking at the individual risks and rewards attached to groups of products or services or in different groups of products or services or in different geographical areas. These are subject to differing rates of profitability, opportunities for growth, future prospects and risks.

## 1.1 Scope of the standard

Only entities whose **equity or debt securities are publicly traded** (ie on a stock exchange) need disclose segment information. In group accounts, only **consolidated** segmental information needs to be shown. (The statement also applies to entities filing or in the process of filing financial statements for the purpose of issuing instruments.)

## 2 Operating segments



**When applying SLFRS 8, in the first instance, operating segments should be identified.**

SLFRS 8 requires that operating segments are identified and the results of reportable operating segments are disclosed.

### 2.1 Definition

SLFRS 8 defines an operating segment as follows.



An **operating segment** is a component of an entity:

- (a) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other items of the same entity)
- (b) Whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance
- (c) For which discrete financial information is available

The term 'chief operating decision maker' identifies a function, not necessarily a manager with a specific title. That function is to allocate resources and to assess the performance of the entity's operating segments.

### 2.2 Aggregation

Two or more operating segments may be aggregated if the segments have similar economic characteristics, and the segments are similar in **each** of the following respects:

- The nature of the products or services
- The nature of the production process

- The type or class of customer for their products or services
- The methods used to distribute their products or provide their services
- If applicable, the nature of the regulatory environment

### 3 Reportable segments



**An operating segment is only reportable if it meets certain quantitative thresholds.**

An entity must report separate information about each operating segment that:

- Has been identified as meeting the definition of an operating segment
- Meets the SLFRS 8 quantitative thresholds

#### 3.1 Quantitative thresholds

In order for an identified operating segment to be reportable, the segment total should be 10% or more of the total:

- Revenue (internal and external)
- All segments not reporting a loss (or all segments in loss if greater), or
- Assets

#### 3.2 Additional requirements

At least 75% of total external revenue must be reported by operating segments. Where this is not the case, additional segments must be identified (even if they do not meet the 10% thresholds).

Two or more operating segments below the thresholds may be aggregated to produce a reportable segment if the segments have similar economic characteristics, and the segments are similar in a majority of the aggregation criteria above.

Operating segments that do not meet any of the quantitative thresholds may be reported separately if management believes that information about the segment would be useful to users of the financial statements.

### 3.3 Decision tree

The following decision tree will assist in identifying reportable segments.

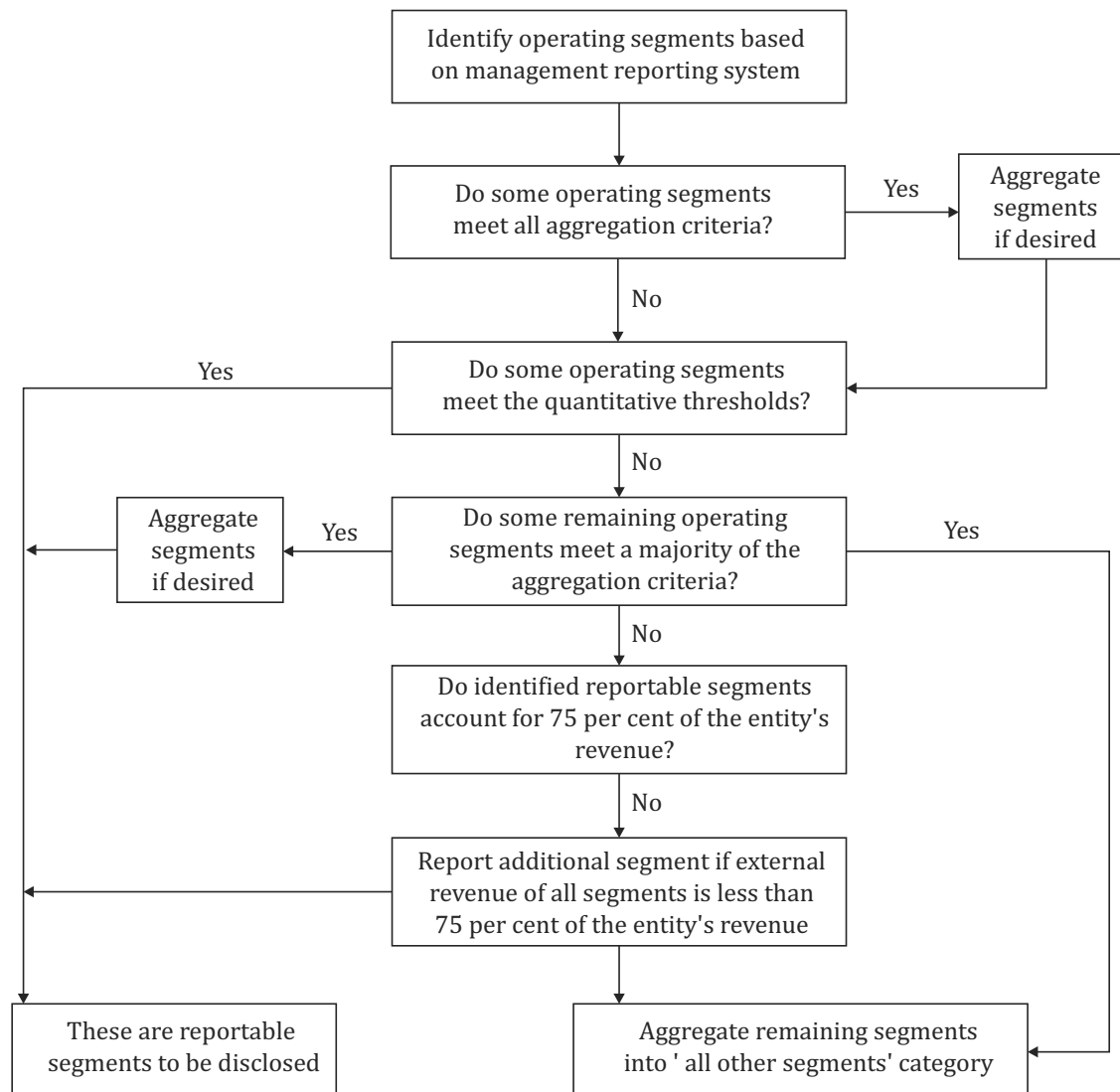


Figure 19.1



#### QUESTION

#### Reportable operating segments

Jasmine PLC, a retail and leisure group, has three businesses operating in different parts of the world. Jasmine reports to management on the basis of region. The results of the regional segments for the year ended 31 December 20X9 are as follows.

Region	Revenue		Segment results profit/(loss)	Segment assets	Segment liabilities
	External Rs million	Internal Rs million			
European	200	3	(10)	300	200
North America	300	2	60	800	300
Other regions	500	5	105	2,000	1,400

There were no significant intra-group balances in the segment assets and liabilities. The retail outlets and leisure centres are located in capital cities in the various regions, and the company sets individual performance indicators for each hotel based on its city location.

### Required

**Discuss** how the principles in SLFRS 8 *Operating segments* for the determination of a company's reportable operating segments would be applied for Jasmine PLC, using the information given above.

### ANSWER

SLFRS 8 *Operating segments* states that an operating segment is reported separately if:

- (i) It meets the definition of an operating segment
- (ii) It exceeds at least one of the quantitative thresholds

For Jasmine, the thresholds are as follows.

- (i) Combined revenue is Rs. 1,010m, so 10% is Rs. 101m.
- (ii) Combined reported profit is Rs. 165m, so 10% is Rs. 16.5m.
- (iii) Combined reported loss is Rs. 10m, so 10% is Rs. 1m.
- (iv) Total assets are Rs. 3,100m, so 10% is Rs. 310m.

The North America segment meets the criteria, passing all three tests. Its combined revenue is Rs. 302m; its reported profit is Rs. 60m, and its assets are Rs. 800m.

The European segment also meets the criteria, but only marginally. Its reported revenue, at Rs. 203m is greater than 10% of combined revenue, and only one of the tests must be satisfied. However, its loss of Rs. 10m is less than the greater of 10% of combined profit and 10% of combined loss, so it fails this test. It also fails the assets test, as its assets, at Rs. 300m, are less than 10% of combined assets (Rs. 310m).

SLFRS 8 requires that at least 75% of total external revenue must be reported by operating segments. Currently, only 50% is so reported. Additional operating segments (the 'other regions') must be identified until this 75% threshold is reached.

## 4 Disclosure



SLFRS 8 requires disclosure of:

- Operating segment profit or loss
- Segment assets
- Segment liabilities
- Certain income and expense items

Disclosures are also required about the revenues derived from products or services and about the countries in which revenues are earned or assets held, even if that information is not used by management in making decisions.

Disclosures required by the SLFRS are extensive, and best learned by looking at the example and proforma, at the end of this section.

### 4.1 General information

- (a) Factors used to identify the entity's reportable segments
- (b) Judgements made by management in applying the aggregation criteria
- (c) **Types of products and services** from which each reportable segment derives its revenues
- (d) **External revenue** by each product and service (if reported basis is not products and services)

### 4.2 Information about profit or loss, assets and liabilities

Reportable segment revenues, profit or loss, assets, liabilities and other material items are shown below.

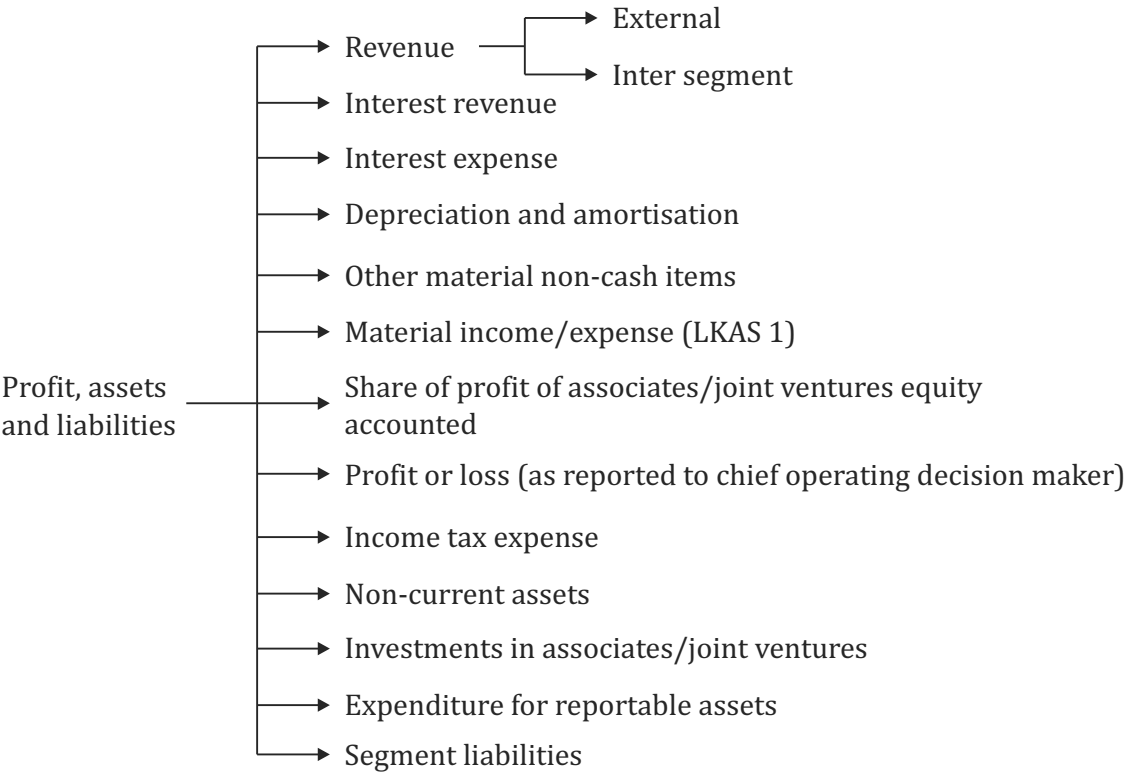


Figure 19.2

A **reconciliation** of each of the above material items to the entity's reported figures is required.

Reporting of a measure of **profit or loss** and **total assets** by segment is compulsory. Other items are disclosed if included in the figures reviewed by, or regularly provided to, the chief operating decision maker.

### 4.3 Information about geographical areas

Geographical information should be reported unless the necessary information is not available and the cost to develop it would be excessive.

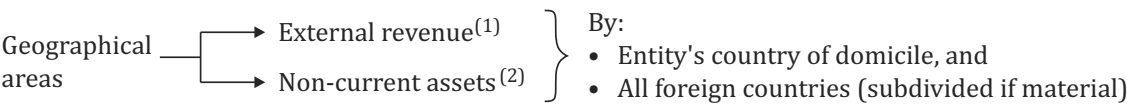


Figure 19.3

**Notes**

- 1 External revenue is allocated based on the customer's location.
- 2 Non-current assets excludes financial instruments, deferred tax assets, post-employment benefit assets, and rights under insurance contracts.



## 4.4 Information about major customers

Information about reliance on major customers (ie those who represent more than 10% of external revenue) should be provided.

## 4.5 Disclosure example from SLFRS 8

The following example is adapted from the SLFRS 8 *Implementation guidance*, which emphasises that this is for illustrative purposes only and that the information must be presented in the most understandable manner in the specific circumstances.

The hypothetical company does not allocate tax expense (tax income) or non-recurring gains and losses to reportable segments. In addition, not all reportable segments have material non-cash items other than depreciation and amortisation in profit or loss. The amounts in this illustration are assumed to be the amounts in reports used by the chief operating decision maker.

	<i>Car parts</i> Rs	<i>Motor vessel</i> Rs	<i>Software</i> Rs	<i>Electronics</i> Rs	<i>Finance</i> Rs	<i>All other</i> Rs	<i>Totals</i> Rs
Revenues from external customers	3,000	5,000	9,500	12,000	5,000	1,000 <sup>(a)</sup>	35,500
Intersegment revenues	–	–	3,000	1,500	–	–	4,500
Interest revenue	450	800	1,000	1,500	–	–	3,750
Interest expense	350	600	700	1,100	–	–	2,750
Net interest revenue <sup>(b)</sup>	–	–	–	–	1,000	–	1,000
Depreciation and amortisation	200	100	50	1,500	1,100	–	2,950
Reportable segment profit	200	70	900	2,300	500	100	4,070
Other material non-cash items:							
Impairment of assets	–	200	–	–	–	–	200
Reportable segment assets	2,000	5,000	3,000	12,000	57,000	2,000	81,000
Expenditure for reportable segment non-current assets	300	700	500	800	600	–	2,900
Reportable segment liabilities	1,050	3,000	1,800	8,000	30,000	–	43,850

- (a) Revenues from segments below the quantitative thresholds are attributable to four operating segments of the company. Those segments include a small property business, an electronics equipment rental business, a software consulting practice and a warehouse leasing operation. None of those

segments has ever met any of the quantitative thresholds for determining reportable segments.

- (b) The finance segment derives a majority of its revenue from interest. Management primarily relies on net interest revenue, not the gross revenue and expense amounts, in managing that segment. Therefore, as permitted by SLFRS 8, only the net amount is disclosed.

#### 4.5.1 Suggested proforma

##### Information about profit or loss, assets and liabilities

	<i>Segment A</i>	<i>Segment B</i>	<i>Segment C</i>	<i>All other segments</i>	<i>Inter segment</i>	<i>Entity total</i>
Revenue – external customers	X	X	X	X	–	X
Revenue – inter segment	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>	<u>–</u>
	X	X	X	X	(X)	X
Interest revenue	X	X	X	X	(X)	X
Interest expense	(X)	(X)	(X)	(X)	X	(X)
Depreciation and amortisation	(X)	(X)	(X)	(X)	–	(X)
Other material non-cash items	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)
Material income/expense (IAS 1)	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)
Share of profit of associate/JVs	X	X	X	X	–	X
Segment profit before tax	X	X	X	X	(X)	X
Income tax expense	(X)	(X)	(X)	(X)	–	(X)
Unallocated items						<u>X/(X)</u>
Profit for the year						<u>X</u>
Segment assets	X	X	X	X	(X)	X
Investments in associate/JVs	X	X	X	X	–	X
Unallocated assets						<u>X</u>
Entity's assets						<u>X</u>

	<i>Segment A</i>	<i>Segment B</i>	<i>Segment C</i>	<i>All other segments</i>	<i>Inter segment</i>	<i>Entity total</i>
Expenditures for reportable assets	X	X	X	X	(X)	X
Segment liabilities	X	X	X	X	(X)	X
Unallocated liabilities						X
Entity's liabilities						X

**Information about geographical areas**

	<i>Country of domicile</i>	<i>Foreign countries</i>	<i>Total</i>
Revenue – external customers	X	X	X
Non-current assets	X	X	X



## CHAPTER ROUNDUP

- ↪ An important aspect of reporting financial performance is **segment reporting**. This is covered by SLFRS 8 *Operating segments*.
- ↪ **When applying SLFRS 8, in the first instance, operating segments should be identified.**
- ↪ **An operating segment is only reportable if it meets certain quantitative thresholds.**
- ↪ SLFRS 8 requires disclosure of:
  - Operating segment profit or loss
  - Segment assets
  - Segment liabilities
  - Certain income and expense items

Disclosures are also required about the revenues derived from products or services and about the countries in which revenues are earned or assets held, even if that information is not used by management in making decisions.


**PROGRESS TEST**

- 1 To what entities does SLFRS 8 apply?
- 2 Who or what is the chief operating decision maker?
- 3 What are the quantitative thresholds?
- 4 What general information disclosures are required?
- 5 Which of the following need not be disclosed for reportable operating segments?
  - A Revenue
  - B Depreciation
  - C Administrative expenses
  - D Income tax expense
- 6 Which of the following statements about SLFRS 8 operating segments is/are correct?
  - 1 At least 75% of total revenue must be reported by operating segments.
  - 2 Information about customers who represent more than 5% of external revenue must be disclosed.
  - A 1 only
  - B 2 only
  - C Both 1 and 2
  - D Neither 1 nor 2
- 7 What geographical information should be disclosed for reportable operating segments?
  - A External revenue and non-current assets
  - B Total revenue and non-current assets
  - C External revenue and total assets
  - D Total revenue and total assets

## ANSWERS TO PROGRESS TEST

- 1 Entities with publicly listed shares or debt.
- 2 This is a function that allocates resources and assesses the performance of an entity's operating segments. It is not necessarily a person.
- 3 Segment total is 10% or more of total:
  - (i) Revenue (internal and external)
  - (ii) All segments not reporting a loss (or all segments in loss if greater), or
  - (iii) Assets
- 4
  - (a) Factors used to identify the entity's reportable segments
  - (b) Judgements made by management in applying the aggregation criteria
  - (c) Types of products and services from which each reportable segment derives its revenues
- 5 The answer is **C**. The standard does not require the disclosure of administrative expenses.
- 6 The answer is **D**. At least 75% of external revenue must be reported by operating segments.  
 Information about customers who represent more than **10%** of external revenue must be disclosed.
- 7 The answer is **A**. External revenue and non-current assets

# Earnings Per Share

## INTRODUCTION

**Earnings per share (EPS)** is widely used by investors as a measure of a company's performance, and is of particular importance in comparing the results of a company over a period of time and comparing the performance of one company's equity against the performance of another company's equity.

LKAS 33 details how to calculate, present and disclose earnings per share.

Knowledge Component			
2	Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)		
2.2	Level B	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1 Introduction	2.2
2 Basic earnings per share	2.2
3 Diluted earnings per share	2.2
4 Presentation and disclosure	2.2

**LKAS 33 Learning objectives**

- Explain basic earnings per share and diluted earnings per share.
- Compute basic earnings per share and diluted earnings per share.
- Outline the disclosure requirements with regard to earnings per share as per the standard.

**1 Introduction**

**Earnings per share** is a measure of the amount of profits earned by a company for each ordinary share.

LKAS 33 *Earnings per share* is a disclosure standard. It is concerned with calculating the amount of profit attributable to each ordinary share in a year and presenting that amount in the financial statements.

**1.1 Objective of LKAS 33**

The objective of LKAS 33 is to achieve consistency in the calculation of earnings per share (EPS) so as to improve performance comparisons between different entities and the same entity over time.

In order to meet this objective, LKAS 33 prescribes principles for the determination and presentation of earnings per share. It focuses particularly on the 'per share' part of the calculation, as the determination of profits is influenced by a number of other accounting standards.



## 1.2 Scope of LKAS 33

The requirement of LKAS 33 to present earnings per share applies only to:

- Companies whose ordinary shares are traded in a public market (including companies which are in the process of being listed)
- Groups with a parent whose ordinary shares are traded in a public market

Where an entity prepares both separate and consolidated financial statements, earnings per share is only required to be presented on the basis of the consolidated information.

Where a company whose shares are not listed chooses to present earnings per share, they must do so in accordance with LKAS 33.

## 2 Basic earnings per share



**Basic EPS** is calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period.

### 2.1 Definitions

LKAS 33 provides a number of definitions. Most of them are relevant to diluted earnings per share, and we shall consider those definitions in the next section of the chapter. The following definition is relevant to basic earnings per share.



**An ordinary share** is an equity instrument that is subordinate to all other classes of equity instruments.

The standard goes on to clarify that:

- Ordinary shares participate in profit for the period only after other types of shares such as preference shares have participated.
- An entity may have more than one class of ordinary shares.
- Ordinary shares of the same class have the same rights to receive dividends.

### 2.2 Calculation

Basic EPS is calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period.



## FORMULA TO LEARN

Basic EPS =

$$\frac{\text{Net profit/(loss) attributable to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$

## 2.3 Profit attributable to ordinary shareholders

Profit attributable to ordinary shareholders is retained profit for the year (profit after tax), less:

- Profits attributable to the non-controlling interest
- The results of any discontinued operations
- Net profit attributable to preference shareholders

The net profit attributable to preference shareholders does not include amounts already recognised in profit or loss. Dividends paid on redeemable preference shares, for example, are classified as interest for reporting purposes and reported in finance costs. Amounts for which profit should further be adjusted include:

- Preference dividends on non-cumulative preference shares declared in respect of the period
- Preference dividends for cumulative preference shares for the period, **whether or not** they have been declared (**excluding** those paid/declared during the period in respect of previous periods)



### 2.3.1 Example: profits attributable to ordinary shareholders

Purijjala Sugar PLC reported retained profits of Rs. 23m in the year ended 31 December 20X6. The company has the following shares in issue at that date.

10 million ordinary shares	Rs. 21,000,000
5 million redeemable preference shares	Rs. 5,000,000
4 million irredeemable cumulative preference shares	Rs. 8,000,000

Fixed dividends are paid on the preference shares at a rate of 2% of carrying value for the redeemable shares and 4.5% of carrying amount for the irredeemable shares.

There have been no issues of shares during the year.

### Required

**Calculate** the basic earnings per share for the year ended 31 December 20X6.

**Solution**

	Rs
Profit after tax	23,000,000
Irredeemable preference share dividend $4.5\% \times 8,000,000$	<u>(360,000)</u>
Profit attributable to ordinary shareholders	<u>22,640,000</u>
Basic earnings per share is therefore 226.4 cents (Rs. 22,640,000/10,000,000 ordinary shares).	

**Note.** The redeemable preference share dividend is already charged against profit for the year as part of finance costs.

**2.4 Weighted average number of ordinary shares**

The number of ordinary shares used should be the weighted average number of ordinary shares during the period.

This figure should be **adjusted for events** that have changed the number of shares outstanding without a corresponding change in resources, eg a rights or bonus issue, where shares are issued either at a reduced price or for free.

The **time-weighting factor** is the number of days the shares were outstanding compared with the total number of days in the period; a reasonable approximation is usually adequate.

Shares are usually included in the weighted average number of shares from the **date consideration is receivable**, which is usually the date of issue.

The calculation of the weighted average number of shares is best seen through examples of different types of share issue.

**2.4.1 Share issue**

Where new shares are priced at a market price and issued for cash, there is a corresponding increase in resources, which are used to generate profits. The calculation of weighted average number of shares is therefore a simple pro-rating exercise.

**2.4.2 Example: share issue**

Rathnayake Imports PLC has a profit after tax of Rs. 200m. The company had 120 million ordinary shares in issue at 1 January 20X5 and issued a further 30 million on 1 June 20X5 at the full market price for cash.

**Required**

**Calculate** the basic earnings per share for the year ended 31 December 20X5.

**Solution**

Earnings		Rs. 200m
Weighted average number of shares		
1 January 20X5 – 31 May 20X5	$120\text{m} \times 5/12\text{m}$	50 million
1 June 20X5 – 31 December 20X5	$(120 + 30) \times 7/12$	<u>87.5 million</u>
		137.5 million
Therefore basic EPS	$\frac{200,000,000}{137,500,000}$	146 cents

An alternative calculation of the weighted average number of shares is:

Weighted average number of shares  $120\text{m} + (7/12 \times 30\text{m})$  137.5 million

Profits attributable to ordinary shareholders have been generated using ordinary share capital available. Some of this capital was only available for seven months of the year, hence could only generate seven months' worth of profit. By adjusting the denominator of the EPS calculation to reflect that the shares were only in issue for seven months, we are ensuring that we compare like with like.

**2.4.3 Bonus issue**

Where there is a bonus issue, the number of shares in issue increase; however, these are 'free' shares and there is no corresponding increase in resources available to the entity to use to make profits.

This problem is solved by **adjusting the number of ordinary shares outstanding before the event** for the proportionate change in the number of shares outstanding as if the event had occurred at the beginning of the earliest period reported.

**2.4.4 Example: bonus issue**

Fernando Plantations PLC had a profit after tax of Rs. 16m in the year ended 31 December 20X3. This increased to Rs. 19m in the year ended 31 December 20X4. The company had 15 million ordinary shares in issue at 1 January 20X3 and 20X4, and issued a further 5 million on 1 July 20X4 by way of a 1 for 3 bonus issue.

**Required**

**Calculate** the basic earnings per share for the year ended 31 December 20X3 and 20X4.

**Solution****y/e 31 December 20X3 – as initially reported**

Earnings		Rs. 16m
Weighted average number of shares		15 million
Therefore basic EPS	$\frac{16,000,000}{15,000,000}$	107 cents

**y/e 31 December 20X4**

Earnings		Rs. 19m
Weighted average number of shares		
1 January 20X4 – 30 June 20X4	$15\text{m} \times 6/12 \times 4/3^*$	10 million
Bonus issue	<u>5m</u>	
1 July 20X4 – 31 December 20X4	$20\text{m} \times 6/12$	<u>10 million</u>
		20 million
Therefore basic EPS	$\frac{19,000,000}{20,000,000}$	95 cents

\*4/3 is the 'bonus fraction'. It is calculated based on the number of shares in issue after the bonus issue over the number of shares in issue before the bonus issue. Here  $(15\text{m} + 5\text{m})/15\text{m} = 20/15 = 4/3$ .

The bonus fraction is always applied to the number of shares prior to the bonus issue.

**y/e 31 December 20X3 – adjusted EPS**

The 20X3 EPS can be adjusted in two ways:

- (i) By recalculating it with the weighted average number of shares as 20 million:  
 $16,000,000/20,000,000 = 80 \text{ cents}$
- (ii) By applying the reciprocal of the bonus fraction to the EPS originally calculated:  
 $107 \text{ cents} \times 3/4 = 80 \text{ cents}$

**2.4.5 Rights issue**

A rights issue of shares is an issue of new shares to existing shareholders **at a price below the current market value**.

For the purposes of calculating EPS, this is treated as a combination of a bonus issue and an issue at fair value.

As with a bonus issue, a bonus fraction is used to calculate weighted average number of ordinary shares; this is calculated as:

$$\frac{\text{Pre rights issue price of shares}}{\text{Theoretical ex - rights price (TERP)}}$$

The TERP is calculated as:

$$\frac{\text{Total market value of original shares pre rights issue} + \text{proceeds of rights issue}}{\text{Number of shares post rights issue}}$$

This is the theoretical price at which the shares would trade after the rights issue.

As before, the bonus fraction is used to adjust the number of shares pre rights issue, and its reciprocal can be used to re-calculate the comparative EPS for the prior year.



#### 2.4.6 Example: rights issue

Rupasinghe Industries PLC had a profit after tax of Rs. 30m in the year ended 31 December 20X3. This increased to Rs. 32m in the year ended 31 December 20X4. The company had 25 million ordinary shares in issue at 1 January 20X3 and 20X4 and issued a further 5 million on 1 July 20X4 by way of a 1 for 5 rights issue. The market price of one share immediately before the rights issue was Rs. 4.50; the exercise price was Rs. 3.30.

#### Required

**Calculate** the basic earnings per share for the year ended 31 December 20X3 and 20X4.

#### Solution

##### y/e 31 December 20X3 – as initially reported

Earnings		Rs. 30m
Weighted average number of shares		25 million
Therefore basic EPS	$\frac{30,000,000}{25,000,000}$	120 cents

##### y/e 31 December 20X4

$$(1) \quad \text{TERP} = \frac{25\text{m} \times \text{Rs. } 4.50 + (5\text{m} \times \text{Rs. } 3.30)}{30\text{m}} = \text{Rs. } 4.30$$

$$(2) \quad \text{Bonus fraction} = \frac{4.50}{4.30}$$

(3) Weighted average number of shares

1 January 20X4 – 30 June 20X4  $25\text{m} \times 6/12 \times 4.5/4.3$  13,081,395

Bonus issue 5m

1 July 20X4 – 31 December 20X4  $30\text{m} \times 6/12$  15,000,000  
28,081,395

(4) Basic EPS  $\frac{32,000,000}{28,081,395}$  113 cents

**y/e 31 December 20X3 – adjusted EPS**

$120 \text{ cents} \times 4.3/4.5 = 115 \text{ cents}$



## QUESTION

## Rights issue

Hippala Hotels PLC has produced the following net profit figures for the years ending 31 December.

	Rs million
20X6	1.1
20X7	1.5
20X8	1.8

On 1 January 20X7, the number of shares outstanding was 500,000. During 20X7, the company announced a rights issue with the following details.

Rights: 1 new share for each 5 outstanding (100,000 new shares in total)

Exercise price: Rs. 5

Last date to exercise rights: 1 March 20X7

The market (fair) value of one share in Hippala Hotels immediately prior to exercise on 1 March 20X7 = Rs. 11.

## Required

**Calculate** the EPS for 20X6, 20X7 and 20X8.

## ANSWER

(1) TERP

This computation uses the total fair value and number of shares.

$$\frac{\text{Fair value of all outstanding shares} + \text{total received from exercise of rights}}{\text{No shares outstanding prior to exercise} + \text{no shares issued in exercise}}$$

$$= \frac{(\text{Rs. } 11 \times 500,000) + (\text{Rs. } 5 \times 100,000)}{500,000 + 100,000} = \text{Rs. } 10$$

## (2) Computation of EPS

		20X6 cents	20X7 cents	20X8 cents
20X6	EPS as originally reported $\frac{\text{Rs. } 1,100,000}{500,000}$	2.20		
20X6	EPS restated for rights issue $\frac{\text{Rs. } 1,100,000}{500,000} \times \frac{10}{11}$ (or $2.20 \times \frac{10}{11}$ )	2.00		
20X7	EPS including effects of rights issue $\frac{\text{Rs. } 1,500,000}{(500,000 \times 2/12 \times 11/10) + (600,000 \times 10/12)}$		2.54	
20X8	EPS = $\frac{\text{Rs. } 1,800,000}{600,000}$			3.00

### 3 Diluted earnings per share



**Diluted EPS** is calculated by adjusting the net profit attributable to ordinary shareholders and the weighted average number of shares outstanding for the effects of all dilutive potential ordinary shares.

#### 3.1 Introduction

At the end of an accounting period, a company may have in issue some **securities** which do not (at present) have any 'claim' to a share of equity earnings, but **may give rise to such a claim in the future**, eg convertible loan stock.

In such circumstances, the future number of ordinary shares in issue might increase, which in turn results in a fall in the EPS.

In some cases, the earnings figure is also affected, eg the conversion of loan stock to ordinary shares will result in a lower interest charge and so higher profits.

The diluted EPS figure is a 'worst case scenario' earnings per share figure which provides the EPS that would have been obtained in the current financial period if a dilution of equity and related effect on profit had already taken place.

#### 3.2 Definitions

LKAS 33 includes a number of definitions that are relevant to diluted earnings per share.



**A potential ordinary share** is a financial instrument or other contract that may entitle its holder to ordinary shares.



**Dilution** is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued on the satisfaction of specified conditions.

**Antidilution** is an increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued on the satisfaction of specified conditions.

**Options, warrants and their equivalents** are financial instruments that give the holder the right to purchase ordinary shares.

### 3.3 Potential ordinary shares

As can be seen above, a potential ordinary share is a financial instrument or other contract that may entitle its holder to ordinary shares. These include:

- (a) **Convertible loan stock or convertible preference shares** which give their holders the right at some future date to exchange their securities for ordinary shares of the company, at a pre-determined conversion rate
- (b) **Options or warrants**
- (c) **Shares that would be issued** on the satisfaction of conditions resulting from contractual arrangements such as the purchase of a business

### 3.4 Dilutive and antidilutive

Potential ordinary shares may be dilutive or antidilutive.

- (a) Dilutive potential ordinary shares decrease EPS on conversion because the number of shares ranking for dividend will increase but profits will not increase proportionately.
- (b) Antidilutive potential ordinary shares increase EPS on conversion because the number of shares ranking for dividend will increase but profits increase to a greater extent.

**When calculating diluted EPS, only dilutive potential ordinary shares are taken into account.** It is therefore important to check each group of potential ordinary shares on a stand alone basis to see whether they are dilutive or antidilutive before calculating diluted EPS.



### 3.4.1 Example: antidilutive potential ordinary shares

Abekoon Electricals PLC has Rs. 20m 10% convertible loan stock in issue. This is convertible in the future at a rate of one share for every Rs. 10 loan stock. The company pays corporate income tax at 28% and has basic EPS of 70 cents.

The effect of the conversion would be:

- (a) An increase in the number of ordinary shares by 2,000,000
- (b) An increase in profits of Rs. 1,440,000 ( $20,000,000 \times 10\% \times (1-28\%)$ )

The earnings per share for the potential ordinary shares is therefore 72 cents ( $1,440,000/2,000,000$ ). This is greater than the basic earnings per share, and so the convertible loan stock is antidilutive and should not be taken into account when calculating diluted earnings per share.

## 3.5 Calculation

Diluted earnings per share is calculated as follows.



### FORMULA TO LEARN

Diluted EPS =

$$\frac{\text{Profits in basic EPS} + \text{effect on profit of dilutive potential ordinary shares}}{\text{Number of shares in basic EPS} + \text{dilutive potential ordinary shares}}$$

The calculation should be performed in steps with each group of dilutive potential ordinary shares added in turn, starting with the most dilutive.

After each addition, diluted EPS is calculated and the diluted earnings per share figure is that which is the lowest calculated at any stage.

### 3.5.1 Profits

The earnings used in diluted EPS are those calculated for basic EPS, adjusted by the **post-tax** effect of:

- (a) Any **dividends** on dilutive potential ordinary shares that were deducted to arrive at earnings for basic EPS
- (b) **Interest recognised** in the period for the dilutive potential ordinary shares (convertible debt)
- (c) Any **other changes in income or expenses** (fees or discount) that would result from the conversion of the dilutive potential ordinary shares

The conversion of some potential ordinary shares may lead to changes in **other income or expenses**. For example, the reduction of interest expense related to

potential ordinary shares and the resulting increase in net profit for the year may lead to an increase in the expense relating to a non-discretionary employee profit-sharing plan. When calculating diluted EPS, the net profit or loss for the year is adjusted for any such consequential changes in income or expense.

### 3.5.2 Number of shares

The number of ordinary shares is the weighted average number of ordinary shares calculated for basic EPS plus the weighted average number of ordinary shares that would be issued on the conversion of the **dilutive potential ordinary shares** into ordinary shares.

It should be assumed that dilutive ordinary shares were converted into ordinary shares at the **beginning of the period** or, if later, at the actual date of issue.

The computation assumes the most **advantageous conversion rate** or exercise rate from the standpoint of the holder of the potential ordinary shares.

### 3.6 Share options

On exercise, share options will increase the number of ordinary shares in issue; however they will not affect profits. For the purposes of calculating diluted EPS, it is assumed that all options will be exercised.

Share options normally have an exercise price below the market price of a share. Therefore, for the purposes of calculating diluted earnings per share, share options are treated as a hybrid of some shares issuable at full market price and a bonus issue. It is the bonus issue element that is dilutive and must be taken into account in the calculation of diluted EPS.

Where the exercise price of share options exceeds average market price in a period, the options are not dilutive.



#### QUESTION

#### Share options

Wijekoon Botanicals PLC has the following results for the year ended 31 December 20X7.

Net profit for year	Rs. 1,200,000
Weighted average number of ordinary shares outstanding during year	500,000 shares
Average fair value of one ordinary share during year	Rs. 20
Weighted average number of shares under option during year	100,000 shares
Exercise price for shares under option during year	Rs. 15

**Required**

**Calculate** both basic and diluted earnings per share.

**ANSWER**

	<i>Per share</i>	<i>Earnings</i> Rs	<i>Shares</i>
Net profit for year		1,200,000	
Weighted average shares outstanding during 20X7			500,000
<i>Basic earnings per share</i>	2.40		
Number of shares under option			100,000
Number of shares that would have been issued at fair value: (100,000 × Rs. 15/Rs. 20)			<u>(75,000) *</u>
<i>Diluted earnings per share</i>	2.29	<u>1,200,000</u>	<u>525,000</u>

\* The earnings have not increased and the total number of shares has increased only by the number of shares (25,000) deemed for the purpose of the computation to have been issued for no consideration.

**3.7 Convertible instruments**

Convertible instruments may include loan stock and preference shares. As we have already seen, these potential ordinary shares may be dilutive or antidilutive.

**3.7.1 Example: convertible instruments**

In 20X7, Dias Products PLC had a basic EPS of 105c based on earnings of Rs. 105,000 and 100,000 ordinary shares. It also had in issue Rs. 40,000 15% convertible loan stock which is convertible in two years' time at the rate of 4 ordinary shares for every Rs. 5 of stock. The rate of tax is 28%.

**Required**

**Calculate** the diluted EPS.

**Solution**

Diluted EPS is calculated as follows.

**Step 1 Number of shares:** the additional equity on conversion of the loan stock will be  $40,000 \times 4/5 = 32,000$  shares.

**Step 2 Earnings:** Dias Products will save interest payments of Rs. 6,000 ( $40,000 \times 15\%$ ) but this increase in profits will be taxed. Hence the earnings figure may be recalculated:

$$(105,000 + (6,000 \times 72\%)) = \text{Rs. } 109,320$$

**Step 3 Calculation:** Diluted EPS =  $\frac{\text{Rs. } 109,320}{132,000} = 82.8\text{c}$

**Step 4 Dilution:** the dilution in earnings would be  $105\text{c} - 82.8\text{c} = 22.2\text{c}$  per share.



## QUESTION

## Convertible loan stock

Alahakoon PLC has 5,000,000 ordinary shares in issue, and also had in issue in 20X4:

- (a) Rs. 1,000,000 of 14% convertible loan stock, convertible in three years' time at the rate of 2 shares per Rs. 10 of stock
- (b) Rs. 2,000,000 of 10% convertible loan stock, convertible in one year's time at the rate of 3 shares per Rs. 5 of stock

The total earnings in 20X4 were Rs. 1,750,000.

The rate of income tax is 28%.

### Required

**Calculate** the basic EPS and diluted EPS.

## ANSWER

- (1) Calculate basic EPS:

$$1,750,000 / 5,000,000 = 35 \text{ cents}$$

- (2) Consider whether the loan stock is dilutive or antidilutive:

14% loan stock:

$$\begin{aligned} \text{Incremental earnings} &= 1,000,000 \times 14\% \times (1 - 28\%) \\ &= \text{Rs. } 100,800 \end{aligned}$$

$$\begin{aligned} \text{Incremental shares} &= 1,000,000 / 10 \times 2 \\ &= 200,000 \end{aligned}$$

$$\begin{aligned} \text{Therefore EPS} &= \text{Rs. } 100,800 / 200,000 \\ &= 50.4 \text{ cents, so antidilutive} \end{aligned}$$

10% loan stock:

$$\begin{aligned}
 \text{Incremental earnings} &= 2,000,000 \times 10\% \times (1-28\%) \\
 &= \text{Rs. } 144,000 \\
 \text{Incremental shares} &= 2,000,000/5 \times 3 \\
 &= 1,200,000 \\
 \text{Therefore EPS} &= \text{Rs. } 144,000/1,200,000 \\
 &= 12 \text{ cents, so dilutive}
 \end{aligned}$$

(3) Calculate diluted EPS:

$$(1,750,000 + 144,000)/(5,000,000 + 1,200,000) = 30.5 \text{ cents}$$

### 3.8 Contingently issuable shares

Where ordinary shares are issuable contingent on a future event occurring, these shares are included in the calculation of diluted EPS based on the number of shares that would be issuable if the end of the period were the end of the contingency period.

- (a) If the shares are issuable on achieving a specified level of earnings after the period end, and that level of earnings has been achieved by the period end, the contingently issuable shares are included in the calculation of diluted EPS.
- (b) If the shares are issuable dependent on the market price of ordinary shares at a date after the period end and the required market price has been achieved at the period end, the contingently issuable shares are included in the calculation of diluted EPS.
- (c) If the shares are issuable dependent on achieving a specified level of earnings and a specified market price at a date after the period end, they are included in diluted EPS only if both conditions are met at the period end.
- (d) If the shares are issuable dependent on another condition, eg opening a certain number of outlets by a given date, they are included in the calculation of diluted EPS according to the status at the period end.

**QUESTION****Diluted EPS**

Meepitiya Mines PLC has 10,000,000 ordinary shares in issue at 31 December 20X4, and also had in issue in 20X4:

- (a) Rs. 1,000,000 of 8.75% convertible loan stock, convertible in three years' time at the rate of 2 shares per Rs. 10 of stock.
- (b) Rs. 2,000,000 of 10% convertible loan stock, convertible in one year's time at the rate of 3 shares per Rs. 5 of stock.

The total earnings in 20X4 were Rs. 3,500,000.

The rate of income tax is 28%.

**Required**

**Calculate** the EPS and diluted EPS.

**ANSWER**

Basic EPS = Rs. 3,500,000/10,000,000 = 35 cents

Diluted EPS:

- (i) Assess whether convertible instruments are dilutive or antidilutive:

8.75% convertible loan stock	$\frac{1,000,000 \times 8.75\% \times (1 - 28\%)}{1,000,000 / 10 \times 2}$	
	$\frac{63,000}{200,000}$	= 31.5 c (dilutive)

10% convertible loan stock	$\frac{2,000,000 \times 10\% \times (1 - 28\%)}{2,000,000 / 5 \times 3}$	
	$\frac{144,000}{1,200,000}$	= 12c (dilutive)

- (ii) Calculate diluted earnings per share bringing each dilutive instrument into the calculation, one at a time, starting with the most dilutive.

Diluted EPS including 10% convertible loan stock:

$$\frac{1,750,000 + 144,000}{5,000,000 + 1,200,000} = 30.5c$$

Diluted EPS including 10% and 8.75% convertible loan stock:

$$\frac{1,750,000 + 144,000 + 63,000}{5,000,000 + 1,200,000 + 200,000} = 30.6c$$

Diluted EPS is therefore 30.5c, as this is the lowest value calculated at any stage in the process.

Note that this does not include the effect of the 8.75% convertible loan stock, despite this being dilutive.

## 4 Presentation and disclosure



**LKAS 33** contains a number of requirements on presentation and disclosure.

### 4.1 Presentation

Basic and diluted EPS should be presented by an entity in the statement of profit or loss for each class of ordinary share that has a different right to share in the net profit for the period. If an entity presents items of profit or loss in a separate statement in accordance with LKAS 1, it should present earnings per share only in that statement.

The basic and diluted EPS should be presented with **equal prominence** for all periods presented.

Disclosure must still be made where the EPS figures (basic and/or diluted) are **negative** (ie a loss per share).

### 4.2 Disclosure

An entity should disclose the following.

- (a) The amounts used as the **numerators** in calculating basic and diluted EPS, and a **reconciliation** of those amounts to the net profit or loss for the period.
- (b) The weighted average number of ordinary shares used as the **denominator** in calculating basic and diluted EPS, and a **reconciliation** of these denominators to each other.

### 4.3 Alternative EPS figures

An entity may present **alternative EPS figures if it wishes**. However, LKAS 33 lays out certain rules where this takes place.

- (a) The weighted average number of shares as calculated under LKAS 33 **must** be used.
- (b) A **reconciliation** must be given if necessary between the component of profit used in the alternative EPS and the line item for profit reported in the statement of comprehensive income.
- (c) Basic and diluted EPS must be shown with **equal prominence**.





## CHAPTER ROUNDUP

- ↪ **Earnings per share** is a measure of the amount of profits earned by a company for each ordinary share.
- ↪ **Basic EPS** is calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period.
- ↪ **Diluted EPS** is calculated by adjusting the net profit attributable to ordinary shareholders and the weighted average number of shares outstanding for the effects of all dilutive potential ordinary shares.
- ↪ **LKAS 33** contains a number of requirements on presentation and disclosure.


**PROGRESS TEST**

- 1 How is basic EPS calculated?
- 2 Give the formula for the 'bonus element' of a rights issue.
- 3 Define 'dilutive potential ordinary share'.
- 4 Why is the numerator adjusted for convertible loan stock when calculating diluted EPS?
- 5 Perera PLC has 350,000 ordinary shares in issue on 1 January 20X4. A further 100,000 shares are issued for cash on 1 May 20X4. What is the weighted average number of ordinary shares for the year ended 31 December 20X4?
  - A 450,000
  - B 416,667
- 6 The basic earnings per share of Da Silva Industries PLC is 134 cents in the year ended 31 December 20X4. The tax rate applicable to the company for the year was 28% and the average share price was Rs. 8.50.  
 The company also has in issue:
  - Options to buy ordinary shares for Rs. 8.80
  - Rs. 3,000,000 6% convertible loan stock, convertible at a rate of 2 shares per \$30 loan stock.
 Which of the potential ordinary shares should be taken into account in the calculation of diluted earnings per share?
  - A Neither of them
  - B The options only
  - C The loan stock only
  - D The options and the loan stock
- 7 Liyanage PLC reports profits after tax of Rs 7.6m in the year ended 31 March 20X4. It has 10 million ordinary shares outstanding throughout the year. It also has the following in issue:
  - 4% irredeemable preference shares with a carrying amount of Rs. 1m
  - 2 million options to buy ordinary shares for Rs 6.70 each
 The average price of an ordinary share in Liyanage in the year was Rs. 8.  
 What is the diluted earnings per share?
  - A 63.0 cents
  - B 73.2 cents
  - C 73.6 cents
  - D 76.0 cents

## ANSWERS TO PROGRESS TEST

- 1 
$$\frac{\text{Net profit / (loss) attributable to ordinary shareholders}}{\text{Weighted average of ordinary share outstanding during the period}}$$
- 2 
$$\frac{\text{Actual cum - rights price}}{\text{Theoretical ex - rights price}}$$
- 3 Dilutive potential ordinary shares are shares that decrease EPS on conversion because the number of shares ranking for dividend will increase but profits will not increase proportionately.
- 4 Because the issue of shares will increase earnings, as the interest on the loan stock will no longer have to be paid.
- 5 The answer is **B**.  

$$(350,000 \times 4/12) + (450,000 \times 8/12) = 416,667 \text{ shares}$$
- 6 The answer is **C**.  

The options are antidilutive, as the exercise price exceeds the average share price for the year.

The convertible loan stock will increase profits by Rs. 129,600 ( $3\text{m} \times 6\% \times (1 - 28\%)$ ) and increase the number of shares by 200,000 ( $3,000,000/30 \times 2$ ). The EPS of the instrument is therefore 64.8 cents ( $129,600/200,000$ ). This is lower than basic EPS, and so the potential ordinary shares are dilutive.
- 7 The answer is **B**.
  - Profits attributable to ordinary shareholders are Rs. 7,560,000 ( $7,600,000 - (1\text{m} \times 4\%)$  preference dividend).
  - Profits are not affected by the options.
  - The options are dilutive since the exercise price is less than the average market price in the year.
  - The options would raise Rs. 13,400,000 ( $2\text{m} \times 6.70$ ) on conversion.
  - This is equivalent to the proceeds raised from the sale of 1,675,000 shares at full price ( $13,400,000/8$ ).
  - Therefore, 325,000 ( $2,000,000 - 1,675,000$ ) shares are 'free' and should be added to the diluted EPS calculation.
  - Diluted EPS is therefore  $7,560,000/10,325,000 = 73.2$  cents.



# Part D - Consolidated financial statements



# Principles of Consolidation

## INTRODUCTION

Consolidation refers to the preparation of financial statements for a group of companies. In order to make economic decisions, investors and other interested parties need to understand the financial position and performance of a group of companies as if it were a single entity.

Legally, individual group companies are separate entities that must prepare financial statements. Therefore, the preparation of additional consolidated financial statements is an example of the concept of commercial substance over legal form.

### Knowledge Component

#### 2 Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)

2.2	Level B	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1	Introduction to group accounts	2.2
2	Group companies and levels of investment	2.2
3	LKAS 27 <i>Separate financial statements</i>	2.2
4	SLFRS 10 <i>Consolidated financial statements</i>	2.2
5	SLFRS 3 <i>Business combinations</i>	2.2

**SLFRS 10, SLFRS 11 and LKAS 28 Learning objectives**

- Prepare consolidated financial statements (consolidated statement of financial position and consolidated statement of profit or loss and other comprehensive income).
- Apply and discuss the criteria used to identify a subsidiary and an associate.
- Apply appropriate procedures to be used in preparing group financial statements.
- Describe associate entity and joint venture arrangement.
- Explain different types of joint arrangement.
- Recognise joint control and significant influence.
- Apply equity method of accounting for investment in associate and joint ventures.
- Describe when to discontinue equity method of accounting.

**SLFRS 3 Learning objectives**

- Explain whether a transaction is a business combination.
- Apply the method of accounting for business combination including simple group structures.
- Apply the principles in determining the cost of a business combination.
- Apply the recognition and measurement criteria for identifiable acquired assets and liabilities and goodwill.
- Compute the goodwill acquired in a business combination.
- Explain the exception to the recognition principle.



# 1 Introduction to group accounts



**Many large businesses consist of several companies controlled by one central or administrative company. Together these companies are called a group. The controlling company, called the parent or holding company, will own some or all of the shares in the other companies, called subsidiaries.**

## 1.1 Introduction

There are many reasons for one company to buy shares in another. For example:

- A company may acquire shares in a supplier to ensure continued supply
- A company may buy shares in a customer to secure a distribution network
- A company may buy the shares of a company to achieve geographical expansion or to enter a new market
- A company may buy shares in a competitor to access its products or know how
- There may be tax or legal reasons for an acquisition

In many countries, company law requires that the results of a group should be presented as a whole. Even where this is not the case, the principle of commercial substance over legal form dictates that group accounts should be prepared.

Unfortunately, it is not possible simply to add all the results of group companies together, and this chapter and those following will teach you how to prepare group financial statements.

In traditional accounting terminology, a group of companies consists of a parent company and one or more subsidiary companies that are controlled by the parent company. There may be other group companies and we shall consider those in the next section of the chapter.

## 1.2 Accounting standards

We will be looking at five accounting standards in this and the next three chapters.

- LKAS 27 *Separate financial statements*
- LKAS 28 *Investments in associates*
- SLFRS 3 *Business combinations*
- SLFRS 10 *Consolidated financial statements*
- SLFRS 11 *Joint arrangements*

These standards are all concerned with different aspects of group accounts, but there is some overlap between them.

Before considering some of these standards, in the next section of the chapter we will look at all the important definitions involved in group accounts, which determine how to treat each particular type of investment in group accounts.

## 2 Group companies and levels of investment



**Where one company controls another, there is a parent-subsidary relationship. Where one company has joint control over another, there is a joint arrangement. Where one company has significant influence over another there is a parent-associate relationship.**

A group of companies includes a parent company and one or more subsidiaries. It may also include one or more associates and joint arrangements.

### 2.1 Definitions

We will look at some of these definitions in more detail later, but they are useful here in that they give you an overview of all aspects of group accounts.



A **group** is a parent and all of its subsidiaries.

A **parent** is an entity that controls one or more subsidiaries.

A **subsidiary** is an entity that is controlled by another entity.

**Control** – an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through power over the investee.

**Power** is existing rights that give the current ability to direct the relevant activities of the investee.

An **associate** is an entity over which an investor has significant influence that is neither a subsidiary nor a joint venture.

**Significant influence** is the power to participate in the financial and operating policy decisions of an investee but is not control or joint control over those policies.

A **joint arrangement** is an arrangement of which two or more parties have joint control.

**Joint control** is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

A **joint venture** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

## 2.2 Accounting treatment

The results of a parent company and its subsidiaries are consolidated, whereas a different treatment is applied to a company that is not controlled by the parent. The following table summarises the applicable treatment.

Investment	Criteria	Required treatment in group accounts
Subsidiary	Control	Full consolidation
Associate	Significant influence	Equity accounting (see Chapter 24)
Joint venture	Joint control	Equity accounting (see Chapter 24)
Investment	Asset held for accretion of wealth/dividend income	As a financial asset (see Chapter 14)

## 2.3 Control

A parent company **controls** its subsidiaries; the results of a parent and its subsidiaries are **consolidated**.

In most cases, control is achieved where the parent company owns a majority of the ordinary shares in the subsidiary (to which normal voting rights are attached). There are circumstances, however, when a company may own only a minority of the voting power in the subsidiary, **but** it still has control.

SLFRS 10 provides a definition of control and identifies three separate elements of control.

An investor controls an investee if, and only if, it has all of the following:

- (1) Power over the investee
- (2) Exposure to, or rights to, variable returns from its involvement with the investee
- (3) The ability to use its power over the investee to affect the amount of the investor's returns

If there are changes to one or more of these three elements of control, then an investor should reassess whether it controls an investee.

Power (as defined above) can be obtained directly from ownership of the majority of voting rights or can be derived from other rights, such as:

- Rights to appoint, reassign or remove key management personnel who can direct the relevant activities
- Rights to appoint or remove another entity that directs the relevant activities
- Rights to direct the investee to enter into, or veto changes to, transactions for the benefit of the investor
- Other rights, such as those specified in a management contract

Significant influence and joint control are discussed in more detail in Chapter 24.

### 3 LKAS 27 *Separate financial statements*



**LKAS 27 requires that investments in group companies are accounted for either at cost or in accordance with LKAS 39/SLFRS 9 in the investor's individual financial statements.**

A parent company will usually produce its own, single company financial statements. LKAS 27 *Separate financial statements* provides accounting guidance to be applied in the preparation of these single company financial statements.

Investments in subsidiaries, joint ventures and associates included in the consolidated financial statements should be **either**:

- (a) Accounted for at **cost**, or
- (b) In accordance with **LKAS 39/SLFRS 9** as a financial asset, or
- (c) Using the equity method described in LKAS 28 (see Chapter 24).

The same accounting must be applied to each category of investments.

Where subsidiaries are classified as held for sale in accordance with SLFRS 5, they should be accounted for in accordance with SLFRS 5 in the parent's separate financial statements (see Chapter 17).

## 4 SLFRS 10 *Consolidated financial statements*



**SLFRS 10 requires a parent to prepare consolidated financial statements and prescribes the principles to be applied in their preparation.**

### 4.1 Introduction



**Consolidated financial statements** are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

When a parent issues consolidated financial statements, it should consolidate all subsidiaries, both foreign and domestic.

### 4.2 Exemption from preparing group accounts

A parent need not present consolidated financial statements if, and only if, all of the following hold.

- (a) The parent is itself a wholly owned subsidiary or it is a partially owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements
- (b) Its securities are not publicly traded
- (c) It is not in the process of issuing securities in public securities markets
- (d) The ultimate or intermediate parent publishes consolidated financial statements that comply with International Financial Reporting Standards

A parent that does not present consolidated financial statements must comply with the LKAS 27 rules on separate financial statements (see previous section).

### 4.3 Exclusion of a subsidiary from consolidation

#### **All subsidiaries must be consolidated**

The rules on exclusion of subsidiaries from consolidation are necessarily strict, because this is a common method used by entities to manipulate their results. If a subsidiary that carries a large amount of debt can be excluded, then the gearing of the group as a whole will be improved. In other words, this is a way of taking debt out of the consolidated statement of financial position.

It has been argued in the past that subsidiaries should be excluded from consolidation on the grounds of dissimilar activities, ie the activities of the subsidiary are so different to the activities of the other companies within the group that to include its results in the consolidation would be misleading. LKAS 27 and SLFRS 10 both reject this argument: exclusion on these grounds is not justified because better (relevant) information can be provided about such subsidiaries by consolidating their results and then giving additional information about the different business activities of the subsidiary.

The previous version of LKAS 27 permitted exclusion where a subsidiary operates under severe long-term restrictions and these significantly impair its ability to transfer funds to the parent. This exclusion has now been removed. Control must actually be lost for exclusion to occur.

## 4.4 Mechanics of consolidation

The mechanics of consolidation are dealt with in the following two chapters. Essentially, the process involves adding together the assets, liabilities, income and expenses of parent and subsidiaries on a line-by-line basis before making consolidation adjustments.

The following considerations dealt with by SLFRS 10 are relevant to the process.

### 4.4.1 Different reporting dates

In most cases, all group companies will prepare accounts to the same reporting date. One or more subsidiaries may, however, prepare accounts to a different reporting date from the parent and the other subsidiaries in the group.

In such cases, the subsidiary may prepare additional statements to the reporting date of the rest of the group, for consolidation purposes. If this is not possible, the subsidiary's accounts may still be used for the consolidation, **provided that:**

- (i) The gap between the reporting dates is three months or less
- (ii) Adjustments are made for the effects of significant transactions or other events that occur between the reporting dates

### 4.4.2 Uniform accounting policies

Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances.

Adjustments must be made where members of a group use different accounting policies, so that their financial statements are suitable for consolidation.

#### 4.4.3 Date of inclusion/exclusion

SLFRS 10 requires the results of subsidiary undertakings to be included in the consolidated financial statements from:

- (a) The date of 'acquisition', ie the **date on which the investor obtains control of the investee**, to
- (b) The date of 'disposal', ie the **date the investor loses control of the investee**

Once an investment is no longer a subsidiary, it should be treated as an associate under LKAS 28 (if applicable) or as a financial asset investment (see Chapter 14).

## 5 SLFRS 3 *Business combinations*



**SLFRS 3 *Business combinations* provides guidance on the measurement of net assets acquired in a business combination and the calculation of goodwill.**

As we have seen, SLFRS 10 defines control and prescribes the accounting procedures to be applied when preparing consolidated financial statements.

SLFRS 3 *Business combinations* should be applied in conjunction with SLFRS 10 when preparing consolidated financial statements; it provides guidance on:

- The recognition and measurement of assets and liabilities acquired when a parent company acquires a subsidiary
- The recognition and measurement of any non-controlling interest in the subsidiary
- The recognition and measurement of goodwill on the acquisition
- Disclosures that should be made in order to provide information to evaluate a business combination

### 5.1 Definitions

The following definitions are provided in SLFRS 3.



**Business combination** is a transaction or event in which an acquirer obtains control of one or more businesses.

**Acquirer** is the entity that obtains control of the acquiree.

**Acquiree** is the business or businesses that the acquirer obtains control of in a business combination.

**Non-controlling interest** is the equity in a subsidiary not attributable, directly or indirectly, to a parent.

**Contingent consideration.** Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met.

**Goodwill** is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

**Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Identifiable.** An asset is identifiable if it either:

- (a) Is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so, or
- (b) Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations

## 5.2 The acquisition method

SLFRS 3 requires that a business combination (such as the acquisition of a subsidiary by a parent company) is accounted for using the acquisition method. This takes a four step approach:

- (1) The acquirer is identified.
- (2) The acquisition date is determined.
- (3) The identifiable assets acquired, liabilities assumed and non-controlling interests in the acquiree are recognised and measured.
- (4) Goodwill is recognised and measured.

### 5.2.1 Identification of acquirer

SLFRS 3 requires that one party is identified as the acquirer, ie a business combination is not a merger.



### 5.2.2 Determination of acquisition date

The acquisition date is the date on which the acquirer gains control of the acquiree. This is usually the date on which consideration is transferred and assets and liabilities are acquired.

### 5.2.3 Recognition and measurement of assets, liabilities and non-controlling interests

Identifiable assets, assumed liabilities and the non-controlling interest should be recognised on acquisition.

The recognition criteria of the Conceptual Framework are applied in doing so and as a result some assets or liabilities that were not previously recognised by the acquiree may be recognised on consolidation. An example is internally generated intangible assets.

Assets and liabilities are recognised at fair value at the acquisition date; the non-controlling interest is measured at either fair value or as a proportion of the net assets of the acquiree.

The recognition and measurement requirements of SLFRS 3 are considered in more detail in Section 5.3.

### 5.2.4 Recognition and measurement of goodwill

Goodwill is the excess of the fair value of consideration transferred plus the non-controlling interest over the fair value of identifiable net assets acquired.

The resulting goodwill may be positive, or in some cases negative.

## 5.3 Goodwill

Goodwill represents the intangible elements of a business (in this case, a subsidiary) that are acquired by the purchaser (here the parent). These elements may include the reputation of the subsidiary, customer loyalty to it and an existing customer base.

Goodwill arises in consolidated financial statements as a consolidation adjustment and is calculated as:

	Rs
Fair value of consideration transferred	X
Non-controlling interest	X
Less fair value of identifiable assets acquired and liabilities assumed	(X)
Goodwill	<u>X</u>



### 5.3.1 Example: goodwill

P Co acquired 100% of S Co at a cost of Rs. 100m. On the acquisition date, the fair value of the identifiable net assets of S Co was Rs. 98m.

In this case, P Co owns 100% of S Co and therefore there is no non-controlling interest.

Goodwill is therefore calculated as the cost of the investment of Rs. 100m less the net assets acquired of Rs. 98m.

Goodwill is therefore Rs. 2m. This is the premium that P Co was willing to pay for the business of S Co.

### 5.3.2 Consideration transferred

One company may buy the shares of another for cash, in exchange for the issue of debt or in a share-for-share exchange.

Regardless of the type of consideration it is included in the calculation of goodwill at the acquisition date fair value.

Note that acquisition costs such as legal fees are not part of consideration transferred; these are recognised as an expense of the acquirer as incurred.

In some cases, consideration is contingent upon a future event, eg the subsidiary achieving a certain level of profits post-acquisition. This contingent consideration is also included in the goodwill calculation at its acquisition date fair value.



### 5.3.3 Example: contingent consideration

Panda Co acquired 100% of the shares in Serpent Co on 1 January 20X3. The agreed consideration was:

- Rs. 250m cash payment immediately
- Rs. 100m cash payment on 1 January 20X4 assuming that Serpent achieves a specified level of revenue growth

The fair value of the identifiable net assets of Serpent Co on the acquisition date was Rs. 210m and the fair value of the contingent consideration was deemed to be Rs. 40m.

Goodwill arising on the acquisition is calculated as:

	Rs million
Cash consideration	250
Fair value of contingent consideration	40
Fair value of identifiable net assets of Serpent Co	(210)
Goodwill	<u>80</u>

In Panda Co's individual financial statements, the acquisition is recorded by:

DEBIT	Investment in Panda	Rs. 290m
CREDIT	Cash	Rs. 250m
CREDIT	Liability	Rs. 40m

### 5.3.4 Non-controlling interest

The non-controlling interest is formed of those parties other than the parent company that hold voting shares in a subsidiary. Where a subsidiary is 100% owned by the parent company, there is no non-controlling interest (NCI).

The NCI forms part of the goodwill calculation because SLFRS 3 treats all providers of equity as shareholders in the group even if they are not shareholders in the parent.

SLFRS 3 allows the option to measure the non-controlling interest at acquisition in one of two ways:

- (a) As the relevant proportion of the fair value of identifiable net assets of the subsidiary at the acquisition date, or
- (b) At fair value

This choice can be applied on a transaction-by-transaction basis, and therefore a parent may measure the NCI in one subsidiary using the first method and the NCI in another using the second method.



### 5.3.5 Example: non-controlling interest

Perera Co acquired 80% of Santana Co in 20X7 at a cost of Rs. 490m. The fair value of the identifiable net assets of Santana Co on this date was Rs. 540m and the fair value of the NCI was Rs. 115m.

If the NCI is measured as a proportion of net assets, goodwill is calculated as:

	Rs million
Consideration transferred	490
NCI (20% × 540m)	108
Fair value of identifiable net assets acquired	<u>(540)</u>
Goodwill	<u>58</u>

If the NCI is measured at fair value, goodwill is calculated as:

	Rs million
Consideration transferred	490
NCI (fair value)	115
Fair value of identifiable net assets acquired	<u>(540)</u>
Goodwill	<u>65</u>

The difference between the two amounts is Rs. 7m. This is equivalent to NCI goodwill. If we consider the same calculation in a different format, this will become more apparent:

If the NCI is measured at fair value, goodwill is calculated as:

	80%	20%
	Rs million	Rs million
Consideration/fair value	490	115
Fair value of identifiable net assets (80%/20%)	<u>(432)</u>	<u>(108)</u>
Goodwill	58	7

Notice that goodwill is not proportionate – there is a control premium associated with an 80% shareholding and hence this is significantly more than 80% of the total goodwill of Rs. 65m.

### 5.3.6 Fair value of identifiable assets acquired and liabilities assumed

SLFRS 3 requires that the net assets of the subsidiary on the acquisition date are measured at fair value for inclusion within the consolidated financial statements and the goodwill calculation. The assets and liabilities must:

- Meet the definitions of assets and liabilities in the Conceptual Framework
- Be part of the business combination transaction rather than the result of separate transactions

Fair value is established in accordance with SLFRS 13 *Fair value measurement* (see Chapter 2). Where carrying amount is not equal to fair value, then either:

- The subsidiary company might incorporate any necessary revaluations in its own financial statements. In this case, we can proceed directly to the calculation of goodwill and in turn the consolidation, taking asset values and reserves figures straight from the subsidiary company's statement of financial position.
- The revaluations may be made as a consolidation adjustment without being incorporated in the subsidiary company's own accounts. In this case, we must make the necessary adjustments to the subsidiary's statement of financial position and in the goodwill calculation.



### 5.3.7 Example: fair value adjustments

Dambulla Co acquired 90% of Alutwewa Co in 20X9 at a cost of Rs. 340m. The carrying amount of the net assets of Alutwewa Co on the acquisition date was Rs. 320m; however the fair value of the identifiable assets of the company was Rs. 350m for the following reasons.

- (a) Alutwewa had developed a brand name with a fair value of Rs. 20m but this was not recognised in its own financial statements.
- (b) Land with a carrying amount of Rs. 65m had a fair value Rs. 10m in excess of this.

The non-controlling interest is measured as a proportion of net assets.

Goodwill on acquisition is calculated as:

	Rs million	Rs million
Consideration transferred		340
NCI (350m × 10%)		35
Carrying amount of identifiable net assets acquired	320	
Brand name	20	
Fair value adjustment – land	<u>10</u>	
		<u>(350)</u>
Goodwill		<u>25</u>

### 5.3.8 Exception to the recognition principle

SLFRS 3 provides limited exceptions to the recognition and measurement principles.

In particular, at KB1 you are required to understand the exception to the recognition principle in respect of contingent liabilities.

Contingent liabilities are defined in Chapter 11 as:

- (a) A possible obligation arising from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity, or
- (b) A present obligation that arises from past events but is not recognised because it is not probable that it will result in a future outflow of benefits or the amount of obligation cannot be measured reliably

SLFRS 3 requires that a contingent liability of an acquiree is recognised in consolidation provided that it is a present obligation arising from past events that can be measured reliably. Unlike in LKAS 37, there is no requirement for an outflow of resources to be probable.

## 5.4 Accounting for goodwill

Goodwill arising on a business combination may be positive or negative.

### 5.4.1 Positive goodwill

Positive goodwill is recognised on the acquisition date as a group asset. It is not amortised, but must be tested for impairment at least annually.

### 5.4.2 Negative goodwill

Negative goodwill is referred to by SLFRS 3 as a bargain purchase. This arises where the acquiring company paid less for the shares in the acquiree than the fair value of the net assets acquired. This may occur where the acquiree is loss-making or where a quick sale is required by the previous shareholder.

Negative goodwill is credited to profit or loss immediately; however, before recognising a gain on a bargain purchase, the acquirer must reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and must recognise any additional assets or liabilities that are identified in that review. The acquirer must then review the procedures used to measure:

- (a) The identifiable assets acquired and liabilities assumed
- (b) The non-controlling interests in the acquiree (if any)
- (c) The consideration transferred

## 5.5 Disclosures

An acquirer must disclose information to enable the users of its financial statements to evaluate the nature and financial effect of a business combination that occurs during the current period or after the end of the period but before the financial statements are authorised for issue. This information should include:

- The name and a description of the acquiree
- The acquisition date
- The percentage of voting equity interests acquired
- The reasons for the business combination
- A qualitative description of the factors that make up the goodwill recognised
- The acquisition date fair value of the total consideration transferred and each major class of consideration
- For contingent consideration:
  - The amount recognised at acquisition
  - A description of the arrangement
  - An estimate of the range of outcomes
- Details of acquired receivables

- Amounts recognised for each class of assets and liabilities acquired
- Disclosure in accordance with LKAS 37 for contingent liabilities recognised
- The amount of a gain in a bargain purchase and a description of reasons why the transaction resulted in a gain
- The amount of any non-controlling interests and the measurement basis applied
- Valuation techniques used to determine the fair value of the non-controlling interests where relevant



## QUESTION

## Goodwill

P Co acquired 75% of S Co's 80m shares on 1 January 20X6. It paid Rs. 25 per share, and agreed to pay a further Rs. 1,080m on 1 January 20X7. The following details are relevant to the acquisition date.

- The fair value of the non-controlling interest was Rs. 250m.
- The carrying amount of the net assets of S Co was Rs. 2,300m.
- The fair value of S Co's head office was determined to exceed its carrying amount by Rs. 50m.
- S Co had not recognised a publishing title in its own statement of financial position; this was deemed to have a fair value of Rs. 8m.
- S Co had disclosed a contingent liability resulting from a legal case. The maximum exposure was Rs. 25m and the fair value of the contingent liability was estimated to be Rs. 15m.

The parent company's cost of capital is 8%.

### Required

**Calculate** the goodwill that arises on the acquisition.

## ANSWER

Consideration transferred	Rs million
80m shares $\times$ 75% $\times$ Rs. 35	1,500
Deferred consideration:	
Rs. 1,080m $\times$ 1/1.08	<u>1,000</u>
	2,500
NCI (at fair value)	250

<b>Fair value of identifiable net assets</b>		
carrying amount	2,300	
Fair value adjustment – head office	50	
Fair value adjustment – intangible	8	
Fair value adjustment – contingent liability	<u>(15)</u>	
		<u>(2,343)</u>
Goodwill		<u>407</u>

Note that at 31 December 20X6, Rs. 80m will be charged to finance costs, being the unwinding of the discount on the deferred consideration. The deferred consideration was discounted by Rs. 80m to allow for the time value of money. At 1 January 20X7, the full amount becomes payable.



**CHAPTER ROUNDUP**

- ↪ Many large businesses consist of several companies controlled by one central or administrative company. Together these companies are called a group. The controlling company, called the parent or holding company, will own some or all of the shares in the other companies, called subsidiaries.
- ↪ Where one company controls another, there is a parent-subsidary relationship. Where one company has joint control over another, there is a joint arrangement. Where one company has significant influence over another, there is a parent-associate relationship.
- ↪ LKAS 27 requires that investments in group companies are accounted for either at cost or in accordance with LKAS 39/SLFRS 9 in the investor's individual financial statements.
- ↪ SLFRS 10 requires a parent to prepare consolidated financial statements and prescribes the principles to be applied in their preparation.
- ↪ SLFRS 3 *Business combinations* provides guidance on the measurement of net assets acquired in a business combination and the calculation of goodwill.


**PROGRESS TEST**

- 1 Which standard deals with the disclosure of group entities?
- 2 What is the maximum time allowed between a subsidiary's reporting date and the group reporting date?
- 3 What three elements are required to establish control?
- 4 What type of accounting is applied to both an associate and a joint venture?
- 5 How is an investment in a subsidiary measured in the individual financial statements of the parent company?
- 6 Which of the following statement is/are true?
  - 1 SLFRS 10 requires that a note to the consolidated financial statements explains any instances where the accounting policy of a subsidiary differs from that of the parent.
  - 2 SLFRS 3 requires that the non-controlling interest is measured in the same way for all acquisitions made by a parent company.
  - A Both
  - B 1 only
  - C 2 only
  - D Neither
- 7 Which of the following statements is correct?
  - A Power must be established by voting rights.
  - B An investment in less than 30% of the shares of another company is presumed to be a financial asset investment rather than an associate or subsidiary.
  - C A contingent asset of a subsidiary is recognised for consolidation purposes at fair value.
  - D A subsidiary operating under severe long-term restrictions must be consolidated.
- 8 P Co acquired 75% of S Co's 1m shares on 1 August 20X4 for consideration of Rs. 285m. At that date, the carrying amount of the net assets of S Co was Rs. 350m and the market value of a share in S Co was Rs. 365. What goodwill arises on the acquisition if the NCI is measured at fair value?
  - A Rs. 7,500,000
  - B Rs. 26,250,000
  - C Rs. 15,000,000
  - D Rs. 22,500,000

## ANSWERS TO PROGRESS TEST

- 1 SLFRS 12 *Disclosure of interests in other entities*
- 2 Three months
- 3
  - Power over the investee
  - Exposure to, or rights to, variable returns from involvement with the investee
  - The ability to use power over the investee to affect the amount of the investor's returns
- 4 Equity accounting
- 5 Either at cost or as a financial asset investment in accordance with LKAS 39/SLFRS 9.
- 6 The answer is **D**. Adjustments are made to bring the accounting policies of the subsidiary into line with group policies; therefore no disclosure is required as there will not be an instance where policy differs.  
  
The method of measurement of the NCI is made on an acquisition-by-acquisition basis.
- 7 The answer is **D**. Power may be established in a number of different ways (see Section 2.3).  
  
An investment in less than **20%** of the shares of another company is presumed to be a financial asset investment rather than an associate or subsidiary.  
  
A contingent **liability** of a subsidiary is recognised for consolidation purposes at fair value.
- 8 The answer is **B**.

	Rs million
Consideration	285
Fair value of NCI ( $250,000 \times 365$ )	91.25
Net assets	<u>(350)</u>
Goodwill	<u>26.25</u>



# Consolidated Statement of Financial Position

## INTRODUCTION

This chapter introduces the **basic procedures** required in preparing a consolidated statement of financial position and gives a formal step plan to follow.

There are plenty of questions in this chapter – work through **all** of them carefully.

Knowledge Component			
<b>2</b>	<b>Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)</b>		
<b>2.2</b>	<b>Level B</b>	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.

3 Preparation of Financial Statements

3.1 Consolidated financial statements	3.1.1	<p>Prepare consolidated financial statements (Consolidated Statement of Financial Position and Consolidated Statement of Comprehensive Income) involving one or two subsidiaries and an associate firm in accordance with SLFRS/LKAS, with emphasis on:</p> <ul style="list-style-type: none"><li>- Elimination of inter-company transactions and balances</li><li>- Fair valuation of purchase consideration and identifiable assets and liabilities of acquired subsidiary</li><li>- Pre- and post-acquisition profits</li><li>- Goodwill or gain on bargain purchase of simple acquisition of a subsidiary</li><li>- Gain/loss on disposal of a subsidiary</li><li>- Non-controlling interest</li><li>- Equity accounting</li></ul>
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**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1 Mechanics of consolidation	2.2, 3.1
2 Goodwill and the acquisition journal	2.2, 3.1
3 Non-controlling interest	2.2, 3.1
4 Fair value adjustments	2.2, 3.1
5 Intra-group transactions	2.2, 3.1
6 Summary	2.2, 3.1

**SLFRS 10, SLFRS 11 and LKAS 28 Learning objectives**

- Prepare consolidated financial statements (consolidated statement of financial position and consolidated statement of profit or loss and other comprehensive income).
- Apply and discuss the criteria used to identify a subsidiary and an associate.
- Apply appropriate procedures to be used in preparing group financial statements.
- Describe associate entity and joint venture arrangement.
- Explain different types of joint arrangement.
- Recognise joint control and significant influence.
- Apply equity method of accounting for investment in associate and joint ventures.
- Describe when to discontinue equity method of accounting.

**1 Mechanics of consolidation**

**SLFRS 10 lays out the procedures for preparing consolidated financial statements. The basic principle is to add across the assets and liabilities of parent and subsidiaries.**

The statement of financial position of a parent and its subsidiaries are combined on a line-by-line basis by adding together like items of assets, liabilities and equity.

A number of consolidation adjustments are then made, in order that the consolidated financial statements should show financial information about the group as if it was a single entity. These adjustments include:

- (a) An acquisition journal which recognises goodwill on the acquisition and eliminates the subsidiary's share capital and pre-acquisition reserves against the cost of the investment in the parent company's financial statements (see Section 2).
- (b) Allocation of the relevant share of post-acquisition profits to the non-controlling interest (NCI) (see Section 3).
- (c) Recognition of the effect of fair value adjustments (see Section 4).
- (d) Elimination of the effects of intra-group trading (see Section 5).

### **1.1 Consolidation schedule**

The initial adding across of assets, liabilities and equity, together with consolidation adjustments are often shown in a consolidation schedule, the layout of which is shown below. Where a schedule is not used, the adjustments to each balance may be shown in a working or as a bracketed calculation on the face of the statement of financial position.

At this stage, you should not worry about the adjustments; they are shown for completeness only, and are explained throughout the rest of the chapter.

Do, however, notice the first three columns, which involve listing out the statement of financial position of the parent and subsidiary, and adding the amounts together. Where there is more than one subsidiary, each has its own column in the schedule.



**Consolidation schedule**

				<b>Adjustments</b>		
	Parent	Subsidiary	Total	Acquisition journal	NCI	Consolidated
	Rs million	Rs million	Rs million	Rs million	Rs million	Rs million
PPE	1,000	450	1,450			1,450
Invt in S	400	-	400	(400)		-
Goodwill	-	-	-	175		175
Current assets	300	150	450			450
	<u>1,700</u>	<u>600</u>	<u>2,300</u>			<u>2,075</u>
Stated capital	200	100	300	(100)		200
Reserves	1,150	300	1,450	(200)	(25)	1,225
NCI	-	-	-	75	25	100
Liabilities	350	200	550			550
	<u>1,700</u>	<u>600</u>	<u>2,300</u>			<u>2,075</u>

Notice the following in the consolidated statement of financial position (the final column):

- There is no investment, because the group does not have an investment (the cost of the investment in the subsidiary in the parent company's statement of financial position has been replaced by the net assets of the subsidiary in the consolidated financial statements).
- The share capital is that of the parent company only (because the 'owners' of the group for whom consolidated financial statements are prepared are the owners of the parent, not the owners of the subsidiary).
- A non-controlling interest balance appears in the equity and reserves section of the statement of financial position.

## 2 Goodwill and the acquisition journal



On acquisition, a consolidation journal is posted to recognise goodwill and the non-controlling interest and eliminate the cost of the investment in the subsidiary and the share capital and pre-acquisition reserves of the subsidiary.

## 2.1 Calculation of goodwill

As we saw in Chapter 21, goodwill is the excess that an acquiring company pays for a subsidiary over the fair value of its net assets. Where one company acquires 100% of another, goodwill is calculated as:

	Rs million
Consideration transferred	X
Net assets acquired:	
Stated capital of subsidiary at acquisition date	(X)
Reserves of subsidiary at acquisition date	<u>(X)</u>
Goodwill	<u>X</u>



### 2.1.1 Example: goodwill

P Co acquired 100% of S company on 1 June 20X4 at a cost of Rs. 800m. At that date, S company had stated capital of Rs. 200m and retained earnings (reserves) of Rs. 500m.

Therefore, goodwill is calculated as:

	Rs million
Consideration transferred	800
Net assets acquired:	
Stated capital of subsidiary at acquisition date	(200)
Retained earnings of subsidiary at acquisition date	<u>(500)</u>
Goodwill	<u>100</u>

This is recognised in the consolidated financial statements by:

DEBIT	Goodwill	Rs. 100m
DEBIT	Stated capital	Rs. 200m
DEBIT	Retained earnings	Rs. 500m
CREDIT	Investment in S	Rs. 800m

The debit entries recognise goodwill and eliminate the subsidiary's stated capital and pre-acquisition retained earnings. The credit entry eliminates the cost of the investment in the parent company's statement of financial position.

## 2.2 The non-controlling interest

Where the parent company acquires less than 100% of a subsidiary, there is a non-controlling interest. The non-controlling interest features in the calculation of goodwill as follows.

	Rs million
Consideration transferred	X
<b>Non-controlling interest</b>	<b>X</b>
	X
Net assets acquired:	
Stated capital of subsidiary at acquisition date	(X)
Reserves of subsidiary at acquisition date	<u>(X)</u>
Goodwill	X

Remember that the non-controlling interest (NCI) can be measured at the acquisition date at either fair value or as a proportion of the net assets of the subsidiary. This choice makes no difference to the mechanics of consolidation; however, you should remember that the measurement of the NCI affects the measurement of goodwill:

- Where the NCI is measured as a proportion of net assets, the resulting goodwill relates to the parent share of the subsidiary only
- Where the NCI is measured at fair value, the resulting goodwill relates to the whole subsidiary



### 2.2.1 Example: goodwill and the NCI

P Co acquired 75% of S company on 1 June 20X4 at a cost of Rs. 400m. At that date, S company had stated capital of Rs. 100m and retained earnings of Rs. 200m. The NCI is measured as a proportion of the net assets of the subsidiary.

Therefore, goodwill is calculated as:

	Rs million
Consideration transferred	400
Non-controlling interest 25% (100 + 200)	<u>75</u>
	475
Net assets acquired:	
Stated capital of subsidiary at acquisition date	(100)
Reserves of subsidiary at acquisition date	<u>(200)</u>
Goodwill	<u>175</u>

This is recognised in the consolidated financial statements by:

DEBIT	Goodwill	Rs. 175m
DEBIT	Stated capital	Rs. 100m
DEBIT	Reserves	Rs. 200m
CREDIT	Investment in S	Rs. 400m
CREDIT	NCI	Rs. 75m

Now turn back to the example consolidation schedule in Section 1.1 of this chapter; you can see that this journal is shown in the first adjustment column.

## 2.3 Fair values

As we saw in Chapter 21, SLFRS 3 requires that the net assets of the subsidiary are stated at fair value on the acquisition date for the purposes of consolidation and the calculation of goodwill.

This may result in fair value adjustments to either increase or decrease the carrying amount of the net assets of the subsidiary.

This further extends the calculation of goodwill as follows:

	Rs million
Consideration transferred	X
Non-controlling interest	<u>X</u>
	X
Net assets acquired:	
Stated capital of subsidiary at acquisition date	(X)
Reserves of subsidiary at acquisition date	(X)
<b>Fair value adjustment</b>	<u><b>X/(X)</b></u>
Goodwill	<u>X</u>



### QUESTION

### Goodwill and fair value adjustments

Pelena Co acquired 80% of Serugolla Co on 1 November 20X5 at a cost of Rs. 900m. At that date, the stated capital of Serugolla was Rs. 250m, retained earnings amounted to Rs. 450m and there was a revaluation surplus of Rs. 50m. The fair value of a piece of land was found to be Rs. 150m in excess of its carrying amount. The NCI is measured at its fair value of Rs. 180m.

### Required

**Calculate** goodwill and state the acquisition journal on the acquisition of Serugolla Co.

### ANSWER

	Rs million
Consideration transferred	900
Non-controlling interest	<u>180</u>
	1,080
Net assets acquired:	
Stated capital of subsidiary at acquisition date	(250)
Reserves of subsidiary at acquisition date (450 + 50)	(500)
Fair value adjustment	<u>(150)</u>
Goodwill	180

**Acquisition journal**

DEBIT	Goodwill	Rs. 180m
DEBIT	Stated capital	Rs. 250m
DEBIT	Retained earnings	Rs. 450m
DEBIT	Revaluation surplus	Rs. 50m
DEBIT	PPE – Land	Rs. 150m
CREDIT	Investment in S	Rs. 900m
CREDIT	NCI	Rs. 180m

Note that the acquisition journal now includes a fair value adjustment to land; this ensures that land is carried at its fair value in the consolidated statement of financial position in accordance with SLFRS 3.

**2.4 Goodwill impairment**

Where goodwill has been impaired since acquisition, the original acquisition journal is still recorded, but this is followed by an impairment journal, which reduces the value of goodwill to recoverable amount:

DEBIT	Retained earnings	X
CREDIT	Goodwill	X

This journal is shown in a separate adjustment column within the consolidation schedule.

**2.5 Gain on a bargain purchase**

In some cases, the calculation of goodwill may result in a negative amount. SLFRS 3 refers to this as a gain on a bargain purchase, although it is more commonly known as 'negative goodwill'.

Negative goodwill is reviewed for accuracy and then credited to profit or loss immediately. The basic consolidation adjustment journal therefore becomes:

DEBIT	Stated capital	Stated capital of S
DEBIT	Retained earnings	Retained earnings of S
CREDIT	Retained earnings	Negative goodwill
CREDIT	Cost of investment	Consideration
CREDIT	NCI	NCI measured at acquisition

**QUESTION****Goodwill**

P acquired 75% of the 50,000 shares in S on 1 January 20X7. The market price of S's shares just before the acquisition was Rs. 1,600. P measures the non-controlling interest at fair value.

The statements of financial position of P and S at 1 January 20X7 were as follows.

	P	S
	Rs'000	Rs'000
Property, plant and equipment	60,000	50,000
Shares in S	<u>68,000</u>	<u>–</u>
	128,000	50,000
Current assets	<u>52,000</u>	<u>35,000</u>
	<u>180,000</u>	<u>85,000</u>
Stated capital	100,000	50,000
Retained earnings	<u>70,000</u>	<u>25,000</u>
	170,000	75,000
Current liabilities	<u>10,000</u>	<u>10,000</u>
	<u>180,000</u>	<u>85,000</u>

**Required**

**Prepare** the consolidation schedule of the P Group at the acquisition date.

**ANSWER**

	Parent	Subsidiary	Total	Acquisition journal	Consolidated
	Rs'000	Rs'000	Rs'000	Rs'000	Rs'000
PPE	60,000	50,000	110,000		110,000
Invt in S	68,000	–	68,000	(68,000)	0
Goodwill	–	–	–	13,000	13,000
Current assets	<u>52,000</u>	<u>35,000</u>	<u>87,000</u>		<u>87,000</u>
	180,000	85,000	265,000		210,000
Stated capital	100,000	50,000	150,000	(50,000)	100,000
Retained earnings	70,000	25,000	95,000	(25,000)	70,000
NCI	–	–	–	20,000	20,000
Liabilities	<u>10,000</u>	<u>10,000</u>	<u>20,000</u>		<u>20,000</u>
	180,000	85,000	265,000		210,000

**Consolidation adjustment**

	Rs million
Consideration transferred	68
Non-controlling interest ( $1,600 \times 25\% \times 50,000$ )	<u>20</u>
	88
Net assets acquired:	
Stated capital of subsidiary at acquisition date	(50)
Reserves of subsidiary at acquisition date	<u>(25)</u>
Goodwill	<u>13</u>

**Acquisition journal**

DEBIT	Goodwill	Rs. 13m
DEBIT	Stated capital	Rs. 50m
DEBIT	Retained earnings	Rs. 25m
CREDIT	Investment in S	Rs. 68m
CREDIT	NCI	Rs 20m

**3 Non-controlling interest**

**Subsequent to initial recognition at the acquisition date the NCI is allocated its share of post-acquisition movements in reserves.**

At a given reporting date, the carrying amount of the non-controlling interest is:

	Rs
NCI as measured at acquisition	X
NCI share of post-acquisition movement in the subsidiary's reserves (ie accumulated total comprehensive income since acquisition)	X
Adjustments (see Sections 4 and 5)	<u>X/(X)</u>
	<u>X</u>

The NCI as measured at acquisition is already brought into the consolidated statement of financial position as part of the acquisition journal.

The NCI share of the post-acquisition movement in the subsidiary's reserves is brought in as a separate adjustment:

DEBIT	Retained earnings/other reserves	X
CREDIT	NCI	X

This journal not only increases the NCI by its share of post-acquisition profits/other comprehensive income but also removes the same amount from group reserves balances.



### 3.1 Example: non-controlling interest and post-acquisition profits

P Co acquired 75% of S company on 1 June 20X4 at a cost of Rs. 400m. At that date, S company had stated capital of Rs. 100m and retained earnings of Rs. 200m. The NCI is measured as a proportion of the net assets of the subsidiary. Since acquisition, S company has made Rs. 100m profits and recorded no other comprehensive income.

In this example, the NCI is initially recognised at 25%  $(100\text{m} + 200\text{m}) = \text{Rs. } 75\text{m}$ . In the post-acquisition period, the NCI balance is increased by  $25\% \times \text{Rs. } 100\text{m}$  profits = Rs. 25m.

Therefore, at the reporting date, the NCI has a carrying amount of  $75\text{m} + 25\text{m} = \text{Rs. } 100\text{m}$ .

Note that S Co must have net assets of Rs. 400m at the reporting date (being Rs. 100m stated capital plus Rs.  $(200 + 100)\text{m}$  retained earnings). The NCI carrying amount is equal to 25% of the net assets of the subsidiary at the reporting date. This is only the case where the NCI is initially measured as a proportion of net assets.

Now turn back to the example consolidation schedule in Section 1.1. You will see that the numbers relate to this example and the second adjustment column shows the journal to record the NCI share of post-acquisition profits.

### 3.2 Loss-making subsidiary

Note that where a subsidiary is loss-making, the NCI share of post-acquisition losses is allocated to the NCI even if this results in the NCI having a deficit balance.



#### QUESTION

#### NCI

Panwatta Co acquired 90% of the Rs. 100m stated capital of Selagama Co on 1 January 20X6 when the retained earnings of Selagama Co were Rs. 300m and the revaluation surplus was Rs. 80m. The fair value of the NCI at this date was Rs. 50m. In the year ended 31 December 20X6, Selagama reported profits of Rs. 60m and a revaluation deficit of Rs. 10m.

What is the carrying amount of the NCI in Selagama at 31 December 20X6 and what consolidation journal is required to record the post-acquisition increase in the carrying amount if:

- (a) The NCI is measured as a proportion of net assets?
- (b) The NCI is measured at fair value?



**ANSWER**

<b>Proportion of net assets</b>	Rs
At acquisition 10% (100m + 300m + 80m)	48
Post-acquisition retained earnings 10% × 60m	6
Post-acquisition revaluation deficit 10% × 10m	<u>(1)</u>
NCI at reporting date	53
<b>Fair value</b>	Rs
At acquisition 10% (100m + 300m + 80m)	50
Post-acquisition retained earnings 10% × 60m	6
Post-acquisition revaluation deficit 10% × 10m	<u>(1)</u>
NCI at reporting date	55

**Journal in both cases**

DEBIT	Group retained earnings	Rs. 6m
CREDIT	Group revaluation surplus	Rs. 1m
CREDIT	NCI	Rs. 5m

The journal:

- Removes Rs. 6m profits automatically added across into group retained earnings in the consolidation schedule and instead allocates them to the NCI.
- Removes Rs. 1m loss automatically added across into group revaluation surplus in the consolidation schedule and instead allocates it to the NCI.

**4 Fair value adjustments**

**Where an asset is subject to a fair value adjustment on acquisition, a subsequent adjustment may be required.**

**4.1 Depreciable assets**

Where a depreciable asset is subject to a fair value adjustment on acquisition for the purposes of consolidation, but this is not reflected in the subsidiary's individual accounts, then subsequent adjustments are required at each reporting date to account for the increase or decrease in depreciation:

- Where an asset is fair valued upwards, then more depreciation must be recognised in the consolidated financial statements than in the subsidiary's individual financial statements.

- (b) Where an asset is fair valued downwards, then less depreciation must be recognised in the consolidated financial statements than in the subsidiary's individual financial statements.



#### 4.1.1 Example: fair value adjustments and depreciable assets

P Co acquired 100% of S Co on 1 January 20X5. On the date of acquisition, the carrying amount of property in S Co's accounts was Rs. 760m. The fair value of the property, which had a remaining useful life of 40 years, was found to be Rs. 920m. No property has been acquired or sold since the acquisition date. At 31 December 20X6, P Co's property had a carrying amount of Rs. 1,300m.

#### Required

What is the carrying amount of property in the consolidated statement of financial position at 31 December 20X6 and what consolidation adjustment journal is required in respect of the depreciation of S's property subsequent to acquisition?

#### Solution

In S Co's individual financial statements used for consolidation purposes, the property will be carried at Rs.  $760\text{m} \times 38/40 \text{ years} = \text{Rs. } 722\text{m}$  at 31 December 20X6.

Therefore, the consolidated carrying amount at 31 December 20X6 is:

	Rs million
P Co property	1,300
S Co property	722
Fair value uplift on acquisition ( $920 - 760$ )	160
Additional depreciation ( $160/40 \times 2 \text{ years}$ )	<u>(8)</u>
Carrying amount	2,174

The initial Rs. 160m fair value uplift is brought into the consolidated statement of financial position as part of the acquisition journal.

The additional depreciation is journalled in by:

DEBIT	Retained earnings	8m
CREDIT	PPE – property	8m

#### 4.1.2 The effect of the non-controlling interest

Where adjustments are made after the acquisition date as a result of a fair value adjustment to the net assets of the subsidiary at acquisition, the subsequent adjustments are allocated in part to the NCI.

Taking the example above, say P Co owned 80% of S Co rather than 100%, then the Rs. 8m additional depreciation is in part attributable to the NCI. Therefore the adjustment journal becomes:

DEBIT	Retained earnings ( $8\text{m} \times 80\%$ )	6.4m
DEBIT	NCI ( $8\text{m} \times 20\%$ )	1.6m
CREDIT	PPE – property	8m

## 4.2 Fair value adjustments subsequently realised

After the acquisition date, an asset (or liability) that has been subject to an acquisition date fair value adjustment may be realised (eg sold). As a result, the fair value adjustment must be transferred to profit or loss.



### 4.2.1 Example: fair value adjustments subsequently realised

P Co acquired 100% of S Co in 20X5 at a cost of Rs. 780m. At the acquisition date, the stated capital of S Co was Rs. 300m and retained earnings were Rs. 400m. In addition, inventory was found to have a fair value Rs. 1m in excess of its carrying amount.

At 31 December 20X5, the inventory had been sold outside the group.

The abbreviated statements of financial position of the two companies at 31 December 20X5 are as follows.

	<i>P Co</i>	<i>S Co</i>
	Rs million	Rs million
PPE	1,190	600
Investment	780	
Current assets	<u>330</u>	<u>260</u>
	2,300	860
Stated capital	400	300
Retained earnings	1,600	460
Liabilities	<u>300</u>	<u>100</u>
	2,300	860

### Required

**Prepare** the consolidated statement of financial position of the P Group at 31 December 20X5.

**Solution**

	<i>P Co</i> Rs million	<i>S Co</i> Rs million	<i>Total</i> Rs million	(W1)	(W2)	<i>Group</i> Rs million
PPE	1,190	600	1,790			1,790
Investment	780	–	780	(780)		–
Goodwill	–	–	–	79		79
Current assets	<u>330</u>	<u>260</u>	<u>590</u>	1	(1)	<u>590</u>
	2,300	860	3,160			2,459
Stated capital	400	300	700	(300)		400
Retained earnings	1,600	460	2,060	(400)	(1)	1,659
Liabilities	<u>300</u>	<u>100</u>	<u>400</u>			<u>400</u>
	2,300	860	3,160			2,459

*Workings**1 Acquisition journal*

Goodwill is:	Rs
Consideration transferred	780
Stated capital	(300)
Retained earnings	(400)
Fair value adjustment – inventory	<u>(1)</u>
Goodwill	79

Therefore:

DEBIT	Goodwill	Rs. 79m
DEBIT	Stated capital	Rs. 300m
DEBIT	Retained earnings	Rs. 400m
DEBIT	Current assets	Rs. 1m
CREDIT	Cost of investment	Rs. 780m

*2 Inventory*

As the inventory has been sold at the reporting date, it must be transferred from inventory to cost of sales in the statement of profit or loss. S Co has already made this adjustment based on the carrying amount of the inventory. As a consolidation adjustment, we must transfer the extra Rs. 1m value by:

DEBIT	Cost of sales (retained earnings)	Rs. 1m
CREDIT	Current assets	Rs. 1m

In this example, the subsidiary is 100% owned, if this were not the case, the debit entry would be allocated between the parent and the NCI in their respective shareholdings.

## 5 Intra-group transactions



**The effects of intra-group transactions must be eliminated from the consolidated financial statements in order to present the group as a single economic entity.**

Intra-group transactions may include:

- Inter-company sales
- Inter-company lending
- Inter-company transfers of PPE

As the purpose of consolidated financial statements is to present the group as a single entity, the effects of these transactions must be eliminated on consolidation so that the consolidated statement of financial position shows only amounts owing to and from third parties.

Adjustments are made for:

- (1) Intra-group balances
- (2) Unrealised profits in inventory and PPE

### 5.1 Intra-group balances

Intra-group balances may include:

- A receivable in one company and a payable in another
- A loan in one company and an investment in another

These balances are eliminated through a consolidation adjustment.



#### 5.1.1 Example: cancellation of intra-group balances

P Co has sold goods to S Co during the year resulting in a receivables balance at the reporting date of Rs. 300,000. In S Co's statement of financial position, there is an inter-company payables balance for the same amount.

The balances are cancelled against each other by:

DEBIT	Payables (S Co)	Rs. 300,000
CREDIT	Receivables (P Co)	Rs. 300,000

#### 5.1.2 Unequal intra-group balances

It is not always the case that an intra-group balance cancels exactly. For example, a payable balance in the parent's books may exceed the receivable balance in the subsidiary's books simply because the subsidiary has sent payment but it has not

yet been received by the parent. In this case, the cash in transit is deemed to have been received and the books are adjusted accordingly so that the outstanding intra-group balances are equal and can be cancelled.



### 5.1.3 Example: unequal intra-group balances

At 31 December 20X4, P Co has an inter-company payable balance of Rs. 900,000 and S Co has an inter-company receivable balance of Rs. 1m. P Co sent payment of Rs. 100,000 on the reporting date; however it has not yet been received by S Co.

#### Required

**Prepare** the two consolidation adjustments required in order to cancel the intra-group balance.

#### Solution

- (1) The cash in transit must be accounted for as received by:

DEBIT	Cash	Rs. 100,000
CREDIT	Receivables	Rs. 100,000

- (2) The intra-group balances are cancelled against one another by:

DEBIT	Payables	Rs. 900,000
CREDIT	Receivables	Rs. 900,000

In the consolidation schedule these adjustments may be posted separately in different columns or together as:

DEBIT	Cash	Rs. 100,000
DEBIT	Payables	Rs. 900,000
CREDIT	Receivables	Rs. 1,000,000

## 5.2 Unrealised profits

Where one group company sells goods to another group company in a reporting period, it is likely to record a profit on the sale. If the second group company has not sold those goods outside the group by the reporting date, the profit is unrealised.

Remember, we are treating the group as a single entity – it is nonsense to say that the group has made a profit by selling something to itself!

Therefore, unrealised profits must be eliminated on consolidation.

### 5.2.1 Calculation of unrealised profits in inventory

There are two common ways in which unrealised profits are calculated.

- (1) As a mark up on cost
- (2) As a margin of selling price

It is important to ensure that you identify the method being used in a question so that you calculate the correct unrealised profit figure.



### 5.2.2 Example: calculation of unrealised profits in inventory

S Co sold two lots of goods to P Co during 20X7:

- (1) At a price of Rs. 400,000 based on a 25% mark up on cost
- (2) At a price of Rs. 400,000 based on a 25% profit margin

All of the goods remain in P Co's warehouse at the period end.

#### Required

What is the unrealised profit on each sale?

In the first case, we are given the selling price and told that this represents cost + 20%. Therefore, the profit must be:

$$\text{Rs. } 400,000 \times 25/125 = \text{Rs. } 80,000$$

In the second case, we are given the selling price and told that profit is 25% of this; therefore the profit is:

$$\text{Rs. } 400,000 \times 25\% = \text{Rs. } 100,000$$

Remember that if the question states that only half or one quarter of the goods remain in stock at the period end, then the calculated profit must be halved or quartered to calculate the unrealised profit.

### 5.2.3 Elimination of unrealised profits in inventory

An unrealised profit must be:

- Removed from the selling company's profits
- Removed from the carrying amount of inventory (The company that bought the inventory will carry it at cost, ie the price that it paid in its own statement of financial position. In the consolidated statement of financial position, however, it must be carried at cost **to the group.**)



### 5.2.4 Example: elimination of unrealised profits in inventory

Polwatta Co owns 80% of Sita Co. It sold Sita Co goods during 20X5 for Rs. 100,000, realising a profit margin of 10%. At the year end, half of these goods remain in stock.

#### Required

- Prepare** the adjustment required to eliminate the unrealised profit from the consolidated financial statements.
- Prepare** the adjustment that would be required if Sita Co had sold the goods to Polwatta Co rather than vice versa.

#### Solution

- The unrealised profit is  $\text{Rs. } 100,000 \times 10\% \times 50\% = \text{Rs. } 5,000$ .

This is eliminated by:

DEBIT	Retained earnings	Rs. 5,000
CREDIT	Inventory	Rs. 5,000

- If Sita had sold the goods, the elimination journal would have been:

DEBIT	Retained earnings (80% × 5,000)	Rs. 4,000
DEBIT	NCI (20% × 5,000)	Rs. 1,000
CREDIT	Inventory	Rs. 5,000

### 5.2.5 Calculation of unrealised profits in PPE

Where one group company has sold an item of PPE to another group company, and that item of PPE remains within the group, the unrealised profit comprises two parts:

- The profit or loss on the sale of the item of PPE
- The increase or decrease in accumulated depreciation



### 5.2.6 Example: calculation of unrealised profits in PPE

P Co sold a machine to S Co on 1 January 20X4 for Rs. 300,000. The machine had a carrying amount of Rs. 250,000 in P Co's books on this date. The remaining useful life of the machine was 10 years at the date of disposal.

#### Required

**Calculate** the unrealised profit in PPE at 31 December 20X5.



**Solution**

(1) The profit on sale on 1 January 20X4 was Rs. 50,000

(2) The excess depreciation since transfer is:

	Rs
Depreciation based on old carrying amount ( $250/10 \times 2$ )	50,000
Depreciation based on transfer price ( $300/10 \times 2$ )	<u>60,000</u>
	10,000

The total unrealised profit is therefore Rs. 50,000 – Rs. 10,000 = Rs. 40,000.

Another way to calculate this amount is to compare carrying amounts of the asset at the reporting date post transfer and if no transfer had occurred:

	Rs
Carrying amount if no transfer ( $250 \times 8/10$ )	200,000
Carrying amount post transfer ( $300 \times 8/10$ )	<u>240,000</u>
	40,000

**5.2.7 Elimination of unrealised profits in PPE**

An unrealised profit must be:

- Removed from the selling company's profits
- Removed from the carrying amount of PPE

The journal adjustments are the same as those seen for inventory.

**5.2.8 Summary**

Remember that the adjustment for unrealised profits depends on which company is the selling company:

Where the **parent company** is the selling company, the required adjustment is:

DEBIT	Retained earnings	X
CREDIT	Inventory/PPE	X

Where the **subsidiary company** is the selling company, the required adjustment is:

DEBIT	Retained earnings	X	(group %)
DEBIT	NCI	X	(NCI %)
CREDIT	Inventory/PPE	X	

**QUESTION****Consolidated statement of financial position**

The draft statements of financial position of Ping Co and Pong Co on 30 June 20X8 were as follows.

**STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20X8**

	<i>Ping Co</i> Rs'000	<i>Pong Co</i> Rs'000
<i>Assets</i>		
<i>Non-current assets</i>		
Property, plant and equipment	50,000	40,000
20,000 ordinary shares in Pong Co at cost	<u>30,000</u>	
	80,000	
<i>Current assets</i>		
Inventory	3,000	8,000
Owed by Ping Co		10,000
Receivables	16,000	7,000
Cash	<u>2,000</u>	<u>—</u>
	<u>21,000</u>	<u>25,000</u>
<i>Total assets</i>	<u>101,000</u>	<u>65,000</u>
<i>Equity and liabilities</i>		
<i>Equity</i>		
Stated capital	45,000	25,000
Revaluation surplus	12,000	5,000
Retained earnings	<u>26,000</u>	<u>28,000</u>
	83,000	58,000
<i>Current liabilities</i>		
Owed to Pong Co	8,000	—
Trade payables	<u>10,000</u>	<u>7,000</u>
	<u>18,000</u>	<u>7,000</u>
<i>Total equity and liabilities</i>	<u>101,000</u>	<u>65,000</u>

Ping Co acquired 80% of Pong Co on 1 July 20X7, when the retained earnings of Pong Co stood at Rs. 6m. The agreed consideration was Rs. 30m cash and a further Rs. 10m on 1 July 20X9. Ping Co's cost of capital is 7%. It has not recorded the deferred consideration. Pong Co has an internally-developed brand name – 'Pongo' – which was valued at Rs. 5m at the date of acquisition and deemed to have a 10-year useful life. There have been no changes in the stated capital or revaluation surplus of Pong Co since that date. At 30 June 20X8, Pong Co had invoiced Ping Co for goods to the value of Rs. 2m and Ping Co had sent payment in full but this had not been received by Pong Co.

There is no impairment of goodwill. It is group policy to measure the non-controlling interest at full fair value. At the acquisition date, the non-controlling interest had a fair value of Rs. 9m.

### Required

**Prepare** the consolidated statement of financial position working schedule for Ping Co as at 30 June 20X8.

## ANSWER

### Consolidated statement of financial position at 30 June 20X8

	Ping Rs '000	Pong Rs '000	Total Rs '000	(W1) Rs '000	(W2) Rs '000	(W3) Rs '000	(W4) Rs '000	(W5) Rs '000	Cons. Rs '000
PPE	50,000	40,000	90,000						90,000
Investment	30,000	-	30,000	8,734	(38,734)				-
Intangible	-	-	-		5,000		(500)		4,500
Goodwill	-	-	-		6,734				6,734
Inventory	3,000	8,000	11,000						11,000
Ping	-	10,000	10,000					(10,000)	-
Receivables	16,000	7,000	23,000						23,000
Cash	<u>2,000</u>	<u>-</u>	<u>2,000</u>					2,000	<u>4,000</u>
	101,000	65,000	166,000						139,234
St capital	45,000	25,000	70,000		(25,000)				45,000
Revaluation surplus	12,000	5,000	17,000		(5,000)				12,000
Retained earnings	26,000	28,000	54,000	(612)	(6,000)	(4,400)	(400)		42,588
NCI	-	-	-		9,000	4,400	(100)		13,300
Pong	8,000	-	8,000					(8,000)	-
Payables	10,000	7,000	17,000						17,000
Deferred consideration	-	-	-	9,346					<u>9,346</u>
	101,000	65,000	166,000						139,234

*Workings*1 *Consideration transferred*

	Rs'000
Cash paid	30,000
Fair value of deferred consideration ( $10\text{m} \times 1/(1.07^2)$ )	<u>8,734</u>
	<u>38,734</u>

The deferred consideration has not been recorded in Ping's accounts. In addition, at the date of the current financial statements, 30 June 20X8, the discount for one year has unwound. The amount of the discount unwound is

	Rs'000
$(10\text{m} \times 1/1.07) - 8,734,000$	612

Recording both of these items is achieved by:

DEBIT Investment in Pong	Rs. 8,734,000
DEBIT Retained earnings	Rs. 612,000
CREDIT Deferred consideration ( $8,734 + 612$ )	Rs. 9,346,000

Tutorial note: The unwinding of the discount is recognised as a finance cost in the consolidated statement of profit or loss.

2 *Calculate goodwill**Goodwill*

	Rs'000
Consideration transferred (W1)	38,734
Fair value of NCI	9,000
Net assets acquired:	
Stated capital	25,000
Revaluation surplus on acquisition	5,000
Retained earnings on acquisition	6,000
Intangible asset – brand name	<u>5,000</u>
	<u>(41,000)</u>
Goodwill	<u>6,734</u>

The consolidation journal is (Rs'000):

DEBIT	Goodwill	6,734
DEBIT	Stated capital	25,000
DEBIT	Revaluation surplus	5,000
DEBIT	Retained earnings	6,000
DEBIT	Intangible asset – brand	5,000
CREDIT	Investment	38,734
CREDIT	NCI	9,000

### 3 *NCI – allocation of post-acquisition retained earnings*

Post-acquisition retained earnings are Rs. 22m × 20% = Rs. 4.4m.

These are allocated to the NCI by (Rs '000):

DEBIT	Retained earnings	4,400
CREDIT	NCI	4,400

### 4 *Amortisation of brand*

A brand was recognised at Rs. 5m at acquisition as a fair value adjustment. This has a useful life of 10 years, and therefore at the reporting date has been depreciated by one year, ie Rs. 5m/10 years = Rs. 500,000.

This is recorded by (Rs'000):

DEBIT	Retained earnings (80%)	400
DEBIT	NCI (20%)	100
CREDIT	Brand	500

### 5 *Intra-group balances*

Pong Co has cash in transit of Rs. 2m, which should be added to cash and deducted from the receivable balance.

Cancel common items: these are the current accounts between the two companies of Rs. 8m each. The adjustment journal is (Rs'000):

DEBIT	Cash	2,000
DEBIT	Payables (owed to Pong)	8,000
CREDIT	Receivables (owed by Ping)	10,000

## 6 Summary



**The group retained earnings and NCI figures can be calculated separately as a check.**

### 6.1 Group retained earnings and the NCI

Throughout the chapter, we have seen that most consolidation adjustments affect group retained earnings and in some cases the NCI.

The year-end balances are comprised of the following.

	<i>Retained earnings</i> Rs	<i>NCI</i> Rs
Parent's retained earnings at reporting date	X	
NCI at acquisition		X
Subsidiary's retained earnings since acquisition	Group %	NCI %
Impairment of goodwill (where NCI measured as proportion of net assets)	(X)	
Impairment of goodwill (where NCI measured at fair value)	(Group %)	(NCI %)
Fair value adjustments subsequent to acquisition	Group %	NCI %
Unrealised profits where P is the seller	(X)	
Unrealised profits where S is the seller	<u>Group %</u>	<u>NCI %</u>
	<u>X</u>	<u>X</u>

## 6.2 Summary of consolidated statement of financial position

Purpose	To show the net assets that P controls and the ownership of those assets
Net assets	Always 100% P plus 100% S, providing P holds a majority of voting rights
Share capital	P only
<i>Reason</i>	Simply reporting to the parent company's shareholders in another form
Retained earnings	100% P plus group share of post-acquisition retained earnings of S less consolidation adjustments
<i>Reason</i>	To show the extent to which the group actually owns total assets less liabilities
Non-controlling interest	Fair value at acquisition (or share of net assets) plus share of post-acquisition retained profit (loss)
<i>Reason</i>	To show the equity in a subsidiary not attributable to the parent

**CHAPTER ROUNDUP**

- ↳ **SLFRS 10 lays out the procedures for preparing consolidated financial statements. The basic principle is to add across the assets and liabilities of parent and subsidiaries.**
- ↳ **On acquisition, a consolidation journal is posted to recognise goodwill and the non-controlling interest and eliminate the cost of the investment in the subsidiary and the share capital and pre-acquisition reserves of the subsidiary.**
- ↳ **Subsequent to initial recognition at the acquisition date, the NCI is allocated its share of post-acquisition movements in reserves.**
- ↳ **Where an asset is subject to a fair value adjustment on acquisition, a subsequent adjustment may be required.**
- ↳ **The effects of intra-group transactions must be eliminated from the consolidated financial statements in order to present the group as a single economic entity.**
- ↳ **The group retained earnings and NCI figures can be calculated separately as a check.**


**PROGRESS TEST**

- 1 What stated capital is reported in the consolidated statement of financial position?
- 2 What is represented by the difference between goodwill when the NCI is measured at fair value and when it is measured as a proportion of net assets?
- 3 Where there is a non-controlling interest, what consolidation journal would be required to allocate post-acquisition losses in the subsidiary?
- 4 How is cash in transit dealt with?
- 5 When is an unrealised profit allocated to the NCI?
- 6 How is an impairment of goodwill recognised when the NCI is measured as a proportion of the net assets of the acquiree?
  - A DEBIT Retained earnings  
DEBIT NCI  
CREDIT Goodwill
  - B DEBIT Retained earnings  
CREDIT Goodwill
  - C DEBIT NCI  
CREDIT Goodwill
  - D DEBIT Revaluation surplus  
CREDIT Goodwill
- 7 P Co acquired 75% of S Co in 20X3. During 20X4, S Co sold goods to P Co for Rs. 100,000 based on a 25% mark up. At the year end, P Co had half of the goods in its warehouse. What adjustment is made to group retained earnings?
  - A DEBIT Rs. 10,000
  - B DEBIT Rs. 20,000
  - C DEBIT Rs. 7,500
  - D DEBIT Rs. 12,500



- 8** P Co acquired 90% of S Co for Rs. 325m on 1 January 20X8. At that date, the fair value of the net assets of S Co was Rs. 330m including an Rs. 2m downwards adjustment for inventory and the fair value of a 10% shareholding was Rs. 28m. Subsequent to acquisition, S Co has made Rs. 80m profits and recognised a revaluation surplus of Rs. 20m.

What are the current goodwill and the NCI balance 31 December 20X8 if the NCI is measured at fair value and goodwill has not been impaired?

- A Goodwill Rs. 23m and the NCI Rs. 38m
- B Goodwill Rs. 25m and the NCI Rs. 38m
- C Goodwill Rs. 23m and the NCI Rs. 36m
- D Goodwill Rs. 25m and the NCI Rs. 36m

## ANSWERS TO PROGRESS TEST

- 1 The parent company's
- 2 NCI goodwill; where the NCI is measured as a proportion of net assets, recognised goodwill relates only to the parent. Where the NCI is measured at fair value, recognised goodwill relates to both the parent and the NCI.
- 3
 

DEBIT	NCI
CREDIT	Retained earnings
- 4 The financial statements of the company that will receive the payment are adjusted
- 5 When the subsidiary is the selling company
- 6 The answer is **B**. The NCI is measured as a proportion of net assets meaning that recognised goodwill relates to the parent only. Therefore the full amount of impairment is charged to retained earnings.
- 7 The answer is **C**. The unrealised profit is  $\text{Rs. } 100,000 \times 25/125 \times \frac{1}{2} = \text{Rs. } 10,000$ . The subsidiary is the selling company, and therefore only 75%, ie Rs. 7,500, is charged to group retained earnings.
- 8 The answer is **A**. Goodwill is  $\text{Rs. } 325 \text{ consideration} + \text{Rs. } 28 \text{ NCI} - \text{Rs. } 330 = \text{Rs. } 23\text{m}$ .  
The NCI is  $\text{Rs. } 28\text{m} + 10\% (80\text{m} + 20\text{m}) = \text{Rs. } 38\text{m}$ .

# Consolidated Statement of Profit or Loss

## INTRODUCTION

This chapter introduces the **basic procedures** required in preparing a consolidated statement of profit or loss. It also deals with consolidated other comprehensive income. As you will see, the procedures are very similar to those used in preparing the consolidated statement of financial position.

Knowledge Component			
<b>2</b>	<b>Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)</b>		
<b>2.2</b>	<b>Level B</b>	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.

3 Preparation of Financial Statements

3.1 Consolidated financial statements

3.1.1

Prepare consolidated financial statements (Consolidated Statement of Financial Position and Consolidated Statement of Profit or Loss and Other Comprehensive Income) involving one or two subsidiaries and an associate firm in accordance with SLFRS/LKAS, with emphasis on:

- Elimination of inter-company transactions and balances
- Fair valuation of purchase consideration and identifiable assets and liabilities of acquired subsidiary
- Pre- and post- acquisition profits
- Goodwill or gain on bargain purchase of simple acquisition of a subsidiary
- Gain/loss on disposal of a subsidiary
- Non-controlling interest
- Equity accounting

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1 Mechanics of consolidation	2.2, 3.1
2 Non-controlling interest	2.2, 3.1
3 Consolidation adjustments	2.2, 3.1
4 Other comprehensive income	2.2, 3.1
5 Disposal of a subsidiary	2.2, 3.1
6 Disclosure of interests in subsidiaries	2.2, 3.1

**SLFRS 10, SLFRS 11 and LKAS 28 Learning objectives**

- Prepare consolidated financial statements (consolidated statement of financial position, consolidated statement of profit or loss and other comprehensive income).
- Apply and discuss the criteria used to identify a subsidiary and an associate.
- Apply appropriate procedures to be used in preparing group financial statements.
- Describe an associate entity and a joint venture arrangement.
- Explain different types of joint arrangement.
- Recognise joint control and significant influence.
- Apply equity method of accounting for investment in associate and joint ventures.
- Describe when to discontinue equity method of accounting.

**SLFRS 12 Learning objectives**

- List information about significant judgements and assumptions in determining control, joint control and significant influence.
- List disclosure requirements under interest in subsidiaries.

# 1 Mechanics of consolidation



**When preparing a consolidated statement of profit or loss, the basic principle is to add across the income and expenses of parent and subsidiaries.**

The statement of profit or loss of a parent and its subsidiaries are combined on a line-by-line basis by adding together like items of income and expenditure. Consolidation adjustments may then be required.

## 1.1 Consolidation schedule

As with the consolidated statement of financial position, it is common to use a consolidation schedule when preparing a consolidated statement of profit or loss. Where a schedule is not used, the adjustments to each balance may be shown in a working or as a bracketed calculation on the face of the statement of profit or loss.

As before, the first columns show the results of the parent and subsidiary individually, and these are totalled before adjustments are put through in additional columns.

Note that where there is more than one subsidiary, each has its own column.

In this example consolidation schedule, it is assumed that the parent owns 100% of the subsidiary and therefore there is no reference to the non-controlling interest.

**Consolidation schedule**

				<b>Adjustments</b>		
	Parent	Subsidiary	Total	Eliminate dividend	I-co sales	Consolidated
	Rs million	Rs million	Rs million	Rs million	Rs million	Rs million
Revenue	1,000	500	1,500		(100)	1,400
Cost of sales	<u>(400)</u>	<u>(200)</u>	<u>(600)</u>		100	<u>(500)</u>
Gross profit	600	300	900			900
Distribution costs	(150)	(75)	(225)			(225)
Admin Expenses	(200)	(100)	(300)			(300)
Dividend from subsidiary	<u>50</u>	<u>-</u>	<u>50</u>	(50)		<u>-</u>
Operating profit	300	125	425			375
Finance costs	<u>(100)</u>	<u>(10)</u>	<u>(110)</u>			<u>(110)</u>
Profit before tax	200	115	315			265
Income taxes	<u>(45)</u>	<u>(20)</u>	<u>(65)</u>			(65)
Profit for the year	155	95	250			200

Notice that in the consolidated statement of profit or loss (the final column) there is no dividend income, because the group does not have an investment to pay a dividend. The dividend is eliminated by:

DEBIT      Dividend from subsidiary (CSPL)  
CREDIT    Retained earnings (CSOFP)

**1.2 Mid-year acquisitions**

Unlike the statement of financial position, the statement of profit or loss is prepared for the whole financial year. Therefore, where a subsidiary is acquired part way through the year, its results must be pro-rated for inclusion in the schedule.

**Note that you should never pro-rate amounts in the statement of financial position for a mid-year acquisition.**



### 1.2.1 Example: mid-year acquisition

P Co acquired 100% of S Co on 1 October 20X5. The abbreviated results of both companies for the year ended 31 December 20X5 are as follows.

	<i>P Co</i> Rs million	<i>S Co</i> Rs million
Revenue	38,000	24,000
Cost of sales	<u>(17,000)</u>	<u>(13,200)</u>
Gross profit	21,000	10,800
Expenses	<u>(16,300)</u>	<u>(6,000)</u>
Profit before tax	4,700	4,800
Income taxes	<u>(900)</u>	<u>(1,200)</u>
Profit for the year	<u>3,800</u>	<u>3,600</u>

#### Notes

- 1 S Co has not paid a dividend to P Co since acquisition.
- 2 The results of S Co accrue evenly throughout the year.

#### Consolidated statement of profit or loss

	<i>P Co</i> Rs million	<i>S Co × 3/12m</i> Rs million	<i>Consolidated</i> Rs million
Revenue	38,000	6,000	44,000
Cost of sales	<u>(17,000)</u>	<u>(3,300)</u>	<u>(20,300)</u>
Gross profit	21,000	2,700	23,700
Expenses	<u>(16,300)</u>	<u>(1,500)</u>	<u>(17,800)</u>
Profit before tax	4,700	1,200	5,900
Income taxes	<u>(900)</u>	<u>(300)</u>	<u>(1,200)</u>
Profit for the year	<u>3,800</u>	<u>900</u>	<u>4,700</u>

## 2 Non-controlling interest



**The NCI is allocated its share of the profit made by the subsidiary in the reporting period.**

Where there is a non-controlling interest in the subsidiary, the basic consolidation procedure remains as explained in Section 1.

After profit for the year, there are additional line items. These show how much of the profit for the year is allocated to the owners of the parent (ie how much profit remains in the group) and how much is allocated to the non-controlling interest.





## 2.1 Example: non-controlling interest

P Co acquired 75% of the Rs10 million stated capital of S Co on that company's incorporation in 20X3. The summarised statements of profit or loss and movement on retained earnings of the two companies for the year ending 31 December 20X6 are set out below.

	<i>P Co</i>	<i>S Co</i>
	Rs'000	Rs'000
Sales revenue	75,000	38,000
Cost of sales	<u>(30,000)</u>	<u>(20,000)</u>
Gross profit	45,000	18,000
Administrative expenses	<u>(14,000)</u>	<u>(8,000)</u>
Profit before tax	31,000	10,000
Income tax expense	<u>(10,000)</u>	<u>(2,000)</u>
Profit for the year	<u>21,000</u>	<u>8,000</u>
<b>Note:</b> movement on retained earnings		
Retained earnings brought forward	<u>87,000</u>	<u>17,000</u>
Profit for the year	<u>21,000</u>	<u>8,000</u>
Retained earnings carried forward	<u>108,000</u>	<u>25,000</u>

### Required

**Prepare** the consolidated statement of profit or loss and extract from the statement of changes in equity showing retained earnings and non-controlling interest.

### Solution

#### P CO

#### CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X6

	Rs'000
Sales revenue (75 + 38)	113,000
Cost of sales (30 + 20)	<u>(50,000)</u>
Gross profit	63,000
Administrative expenses (14 + 8)	<u>(22,000)</u>
Profit before tax	41,000
Income tax expense (10 + 2)	<u>(12,000)</u>
Profit for the year	<u>29,000</u>
Profit attributable to:	
Owners of the parent	27,000
Non-controlling interest (Rs. 8m × 25%)	<u>2,000</u>
	<u>29,000</u>

- A consolidation schedule is not used in this case, as there are no adjustments and the preparation of the statement of profit or loss is relatively simple.
- The profit attributable to the non-controlling interest is the subsidiary's profit for the year  $\times$  NCI ownership percentage.
- The profit attributable to the owners of the parent is then a balancing figure.

#### STATEMENT OF CHANGES IN EQUITY (EXTRACT)

	<i>Retained earnings</i>	<i>Non-controlling interest</i>	<i>Total equity</i>
	Rs '000	Rs '000	Rs '000
Balance at 1 January 20X6	99,750	6,750	106,500
Profit for the year	<u>27,000</u>	<u>2,000</u>	<u>29,000</u>
Balance at 31 December 20X6	<u>126,750</u>	<u>8,750</u>	<u>135,500</u>

- The group retained earnings brought forward are:
 

	Rs'000
100% $\times$ P's retained earnings b/f	87,000
75% $\times$ S's post-acquisition retained earnings b/f	<u>12,750</u>
	<u>99,750</u>
- The non-controlling interest brought forward is:
 

	Rs'000
25% $\times$ S's stated capital	2,500
25% $\times$ S's post-acquisition retained earnings b/f	<u>4,250</u>
	<u>6,750</u>
- Profit for the year is taken from the consolidated statement of profit or loss.

### 3 Consolidation adjustments



Consolidation adjustments may include the impairment of goodwill, the elimination of intra-group trading and the elimination of unrealised profits.

#### 3.1 Impairment of goodwill

As we saw in the last chapter, goodwill arising on the acquisition of a subsidiary is an asset of the group that is brought into the consolidated statement of financial position as a consolidation adjustment.

It follows that any subsequent impairment of goodwill in the reporting period is brought into the consolidated statement of profit or loss as a consolidation adjustment.

An impairment loss is recorded by:

DEBIT	Administration expenses	X
CREDIT	Goodwill (CSOFP)	X

- (a) Where goodwill relates to the parent only (because the NCI is measured as a proportion of net assets), the loss is allocated to the owners of the parent company.
- (b) Where goodwill relates to the parent and the NCI (because the NCI is measured at fair value), the loss is allocated to the owners of the parent company and the NCI in proportion to their ownership interests.



### 3.1.1 Example: impairment of goodwill

P Co acquired 80% of S Co in 20X1 resulting in Rs. 10m goodwill. The NCI was measured at fair value. The abbreviated results of both companies for the year ended 31 December 20X3 are as follows.

	P Co Rs million	S Co Rs million
Revenue	160,000	75,000
Cost of sales	<u>(90,000)</u>	<u>(50,000)</u>
Gross profit	70,000	25,000
Expenses	<u>(45,000)</u>	<u>(16,000)</u>
Profit before tax	25,000	9,000
Income taxes	<u>(6,000)</u>	<u>(2,000)</u>
Profit for the year	<u>19,000</u>	<u>7,000</u>

**Note.** Goodwill is impaired by 50% in the year.

#### Consolidated statement of profit or loss

	P Co Rs million	S Co Rs million	Total Rs million	Impairment Rs million	Consolidated Rs million
Revenue	160,000	75,000	235,000		235,000
Cost of sales	<u>(90,000)</u>	<u>(50,000)</u>	<u>(140,000)</u>		<u>(140,000)</u>
Gross profit	70,000	25,000	95,000		95,000
Expenses	<u>(45,000)</u>	<u>(16,000)</u>	<u>(61,000)</u>	(5,000)	<u>(66,000)</u>
Profit before tax	25,000	9,000	34,000	(5,000)	29,000
Income taxes	<u>(6,000)</u>	<u>(2,000)</u>	<u>(8,000)</u>		<u>(8,000)</u>
Profit for the year	19,000	7,000	26,000	(5,000)	21,000
Owners of the parent	19,000	5,600	24,600	(4,000)	20,600
NCI		1,400	1,400	(1,000)	400

Note that the profit of S Co for the year is split between the owners of the parent and the NCI in the ratio 80%:20%, as is the impairment loss.

### 3.2 Intra-group trading

Like the consolidated statement of financial position, the consolidated statement of profit or loss should deal with the results of the group as those of a single entity. When one company in a group sells goods to another, the relevant amount is added to the sales revenue of the first company and to the cost of sales of the second. Yet, as far as the entity's dealings with outsiders are concerned, no sale has taken place.

The consolidated figures for sales revenue and cost of sales should represent sales to, and purchases from, outsiders. An adjustment is therefore necessary to reduce the sales revenue and cost of sales figures by the value of intra-group sales during the year:

DEBIT	Revenue	Inter-company sales
CREDIT	Cost of sales	Inter-company sales



#### 3.2.1 Example: intra-group trading

Now suppose that in the above example, as well as the impairment of goodwill, S Co had sold goods to P Co in the year for Rs 20,000. The consolidation schedule now becomes:

#### Consolidated statement of profit or loss

	<i>P Co</i>	<i>S Co</i>	<i>Total</i>	<i>Impairment</i>	<i>I-group trading</i>	<i>Consolidated</i>
	Rs million	Rs million	Rs million	Rs million	Rs million	Rs million
Revenue	160,000	75,000	235,000		(20,000)	215,000
Cost of sales	<u>(90,000)</u>	<u>(50,000)</u>	<u>(140,000)</u>		20,000	<u>(120,000)</u>
Gross profit	70,000	25,000	95,000			95,000
Expenses	<u>(45,000)</u>	<u>(16,000)</u>	<u>(61,000)</u>	(5,000)		<u>(66,000)</u>
Profit before tax	25,000	9,000	34,000	(5,000)		29,000
Income taxes	<u>(6,000)</u>	<u>(2,000)</u>	<u>(8,000)</u>			<u>(8,000)</u>
Profit for the year	19,000	7,000	26,000	(5,000)		21,000
Owners of parent	19,000	5,600	24,600	(4,000)		20,600
NCI		1,400	1,400	(1,000)		400

Note that the adjustment for intra-group trading has no effect on any profit figures – it simply reduces revenue and cost of sales by equal amounts.

### 3.3 Unrealised profits

Any unrealised profits (URP) on intra-group trading should be excluded from the figure for group profits.

As we saw in the last chapter, this will occur whenever goods sold at a profit within the group remain in the inventory of the purchasing company at the year end.

Any unrealised profit is recorded by:

DEBIT	Cost of sales	X
CREDIT	Inventory (SOFPI)	X

All of the debit entry is allocated to the owners of the parent where the parent company is the selling company. Where the subsidiary is the selling company, the debit entry to cost of sales is allocated between the owners of the parent and the NCI in proportion to their ownership interests.



#### 3.3.1 Example: unrealised profits in inventory

Continuing with the above example, let's assume that 1/10 of the goods sold to P Co by S Co remain in stock at the year end. S Co achieved a margin of 20% on these goods. The consolidation schedule now becomes:

#### Consolidated statement of profit or loss

	<i>P Co</i> Rs million	<i>S Co</i> Rs million	<i>Total</i> Rs million	<i>Impairment</i> Rs million	<i>I-group trading</i> Rs million	<i>URP</i> Rs million	<i>Consolidated</i> Rs million
Revenue	160,000	75,000	235,000		(20,000)		215,000
Cost of sales	<u>(90,000)</u>	<u>(50,000)</u>	<u>(140,000)</u>		20,000	(400)	<u>(120,400)</u>
Gross profit	70,000	25,000	95,000			(400)	94,600
Expenses	<u>(45,000)</u>	<u>(16,000)</u>	<u>(61,000)</u>	(5,000)			<u>(66,000)</u>
Profit before tax	25,000	9,000	34,000	(5,000)		(400)	28,600
Income taxes	<u>(6,000)</u>	<u>(2,000)</u>	<u>(8,000)</u>				<u>(8,000)</u>
Profit for the year	19,000	7,000	26,000	(5,000)		(400)	20,600
Owners of parent	19,000	5,600	24,600	(4,000)		(320)	20,280
NCI		1,400	1,400	(1,000)		(80)	320

URP:  $\text{Rs. } 20\text{m} \times 20\% \times 10\% = \text{Rs. } 400,000$

Allocated to owners of parent:  $\text{Rs. } 400,000 \times 80\% = \text{Rs. } 320,000$

Allocated to the NCI:  $\text{Rs. } 400,000 \times 20\% = \text{Rs. } 80,000$

### 3.3.2 Unrealised profits in PPE

The calculation of an unrealised profit in PPE depends on whether the sale of the item of PPE took place in the year.

- (a) Where the sale did not take place in the year, the unrealised profit is the difference between the depreciation charge before the sale and the depreciation charge after the sale.
- (b) Where the sale did take place in the year, the unrealised profit is the difference between the depreciation charge before the sale and the depreciation charge after the sale **plus** the profit or loss on sale.

By removing these effects, amounts reported in the consolidated statement of profit or loss will be the amounts that would have been reported if the intra-group sale of the PPE had never taken place.

The adjustment is normally made against the line item in which depreciation is charged on the PPE transferred.



### 3.3.3 Example: unrealised profits in PPE

Panadura Co has owned 90% of the stated capital of Sigiriya Co for a number of years. On 1 January 20X5, Panadura sold an item of machinery to Sigiriya for Rs. 34m. The carrying amount of the item had been Rs. 40m. The machine had five years remaining of its useful life at the date of transfer. Both companies charge depreciation on machinery to cost of sales.

#### Required

**Prepare** the adjustment required to the consolidated statement of profit or loss of the Panadura Group in the years ended 31 December 20X5 and 20X6.

#### Solution

20X5	Rs
Loss on disposal (34m – 40m)	6m
Decrease in depreciation (40/5 – 34/5)	1.2m

In order to achieve a position as if the machine had never been transferred:

- The loss of Rs. 6m must be removed from cost of sales (so increasing profit by Rs. 6m).
- An additional Rs. 1.2m depreciation must be charged to cost of sales (so decreasing profit by Rs. 1.2m).
- Therefore, the net adjustment is Rs. 4.8m removed from cost of sales (and so increasing profit).

The adjustment journal is:

DEBIT	PPE – machinery (CSOFP)	Rs. 4.8m
CREDIT	Cost of sales	Rs. 4.8m

As Panadura is the selling company, the whole credit to cost of sales is allocated to owners of the parent.

## 20X6

In 20X6, adjustment is made only for the decrease in depreciation. The adjustment must be made on a cumulative basis in the statement of financial position, although only the current year adjustment is recorded in the consolidated statement of profit or loss. Therefore, the adjustment journal is:

DEBIT	Cost of sales	Rs. 1.2m
DEBIT	Retained earnings (CSOFP)	Rs. 1.2m
CREDIT	PPE – machinery (CSOFP)	Rs. 2.4m



## QUESTION

## Unrealised profits in PPE

Continuing with the example used throughout this section of the chapter, assume that S Co transferred a motor vehicle to P Co on 31 December 20X3 for Rs. 6m. The carrying amount of the vehicle had been Rs. 5m. The vehicle has two years of its useful life remaining and depreciation relevant to it is charged to operating expenses.

## Required

**Prepare** the consolidation schedule for the year ended 31 December 20X3 to include all necessary adjustments.

**ANSWER****Consolidated statement of profit or loss**

	<i>P Co</i>	<i>S Co</i>	<i>Total</i>	<i>Impairment</i>	<i>I-group trading</i>	<i>URP Inv</i>	<i>URP PPE</i>	<i>Consol</i>
	Rs million	Rs million	Rs million	Rs million	Rs million	Rs million		Rs million
Revenue	160,000	75,000	235,000		(20,000)			215,000
Cost of sales	<u>(90,000)</u>	<u>(50,000)</u>	<u>(140,000)</u>		20,000	(400)		<u>(120,400)</u>
Gross profit	70,000	25,000	95,000			(400)		94,600
Expenses	<u>(45,000)</u>	<u>(16,000)</u>	<u>(61,000)</u>	(5,000)			(1,000)	<u>(67,000)</u>
Profit before tax	25,000	9,000	34,000	(5,000)		(400)	(1,000)	27,600
Income taxes	<u>(6,000)</u>	<u>(2,000)</u>	<u>(8,000)</u>					<u>(8,000)</u>
Profit for the year	19,000	7,000	26,000	(5,000)		(400)	(1,000)	19,600
Owners of parent	19,000	5,600	24,600	(4,000)		(320)	(800)	19,480
NCI		1,400	1,400	(1,000)		(80)	(200)	120

The transfer took place on the final day of the accounting period, and therefore the unrealised profit is just the Rs. 1m profit on disposal.

As S Co was the selling company, the adjustment is allocated to the owners of the parent and the NCI in proportion to their shareholdings.

**4 Other comprehensive income**

**Other comprehensive income of the parent and subsidiary are added together in the same way as income and expenses. Total comprehensive income is allocated between the parent and non-controlling interest.**

Items of other comprehensive income in the parent and subsidiary's statements of profit or loss and other comprehensive income are totalled to give group other comprehensive income.

Total comprehensive income is allocated to the owners of the parent and the NCI by taking the profit allocated to each and adding the other comprehensive income allocated to each.

**4.1 Example: other comprehensive income**

To continue the example that we have seen throughout this chapter, now we shall assume that both the parent and subsidiary have recorded a revaluation surplus in the year.



The consolidation schedule is now:

	<i>P Co</i>	<i>S Co</i>	<i>Total</i>	<i>Impairment</i>	<i>I-group trading</i>	<i>URP Inv</i>	<i>URP PPE</i>	<i>Consol</i>
	Rs million	Rs million	Rs million	Rs million	Rs million	Rs million		Rs million
Revenue	160,000	75,000	235,000		(20,000)			215,000
Cost of sales	<u>(90,000)</u>	<u>(50,000)</u>	<u>(140,000)</u>		20,000	(400)		<u>(120,400)</u>
Gross profit	70,000	25,000	95,000			(400)		94,600
Expenses	<u>(45,000)</u>	<u>(16,000)</u>	<u>(61,000)</u>	(5,000)			(1,000)	<u>(67,000)</u>
Profit before tax	25,000	9,000	34,000	(5,000)		(400)	(1,000)	27,600
Income taxes	<u>(6,000)</u>	<u>(2,000)</u>	<u>(8,000)</u>					<u>(8,000)</u>
Profit for the year	<b>19,000</b>	<b>7,000</b>	<b>26,000</b>	<b>(5,000)</b>		<b>(400)</b>	<b>(1,000)</b>	<b>19,600</b>
Reval surplus	10,000	5,000	15,000					15,000
Total comp. income	<b>29,000</b>	<b>12,000</b>	<b>41,000</b>	<b>(5,000)</b>		<b>(400)</b>	<b>(1,000)</b>	<b>34,600</b>
<b>Profit attributable to:</b>								
Owners of parent	19,000	5,600	24,600	(4,000)		(320)	(800)	19,480
NCI		1,400	1,400	(1,000)		(80)	(200)	120
<b>TCI attributable to:</b>								
Owners of parent	29,000 <sup>1</sup>	9,600 <sup>2</sup>	38,600	(4,000)		(320)	(800)	33,480
NCI		2,400 <sup>3</sup>	2,400	(1,000)		(80)	(200)	1,120

(1) Rs. 19m profit + Rs. 10m OCI

(2) Rs. 5.6m profit + (80% × Rs. 5m) OCI

(3) Rs. 1.4m profit + (20% × Rs. 5m) OCI

**QUESTION****Consolidated SPLOCI**

On 1 July 20X7, Crystal acquired 60,000 of the 100,000 shares in Pebble, its only subsidiary. The draft statements of profit or loss and other comprehensive income of both companies at 31 December 20X8 are shown below.

	<i>Crystal</i> Rs million	<i>Pebble</i> Rs million
Revenue	43,000	26,000
Cost of sales	<u>(28,000)</u>	<u>(18,000)</u>
Gross profit	15,000	8,000
Other income – dividend received from Pebble	2,000	-
Distribution costs	(2,000)	(800)
Administrative expenses	(4,000)	(2,200)
Finance costs	<u>(500)</u>	<u>(300)</u>
Profit before tax	10,500	4,700
Income tax expense	<u>(1,400)</u>	<u>(900)</u>
Profit for the year	9,100	3,800
Other comprehensive income:		
Gain on property revaluation (Note (i))	-	2,000
Investment in equity instrument	<u>200</u>	<u>-</u>
Total comprehensive income for the year	<u>9,300</u>	<u>5,800</u>

**Additional information:**

- (i) At the date of acquisition, the fair values of Pebble's assets were equal to their carrying amounts with the exception of a building that had a fair value Rs. 1m in excess of its carrying amount. At the date of acquisition, the building had a remaining useful life of 20 years. Building depreciation is charged to administrative expenses. The building was revalued again at 31 December 20X8 and its fair value had increased by an additional Rs. 1m.
- (ii) Sales from Crystal to Pebble were Rs. 6m during the post-acquisition period. All of these goods are still held by Pebble at 31 December 20X8. Crystal marks up all sales by 20%.
- (iii) Despite the property revaluation, Crystal has concluded that goodwill in Pebble has been impaired by Rs. 500,000.
- (iv) It is Crystal's policy to measure the non-controlling interest at full (fair) value.

**Required**

**Prepare** the consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X8.

**ANSWER****Consolidated statement of profit or loss**

	<i>C Co</i>	<i>P Co</i>	<i>Total</i>	<i>Divi</i>	<i>FV adj</i>	<i>I-group</i>	<i>URP</i>	<i>GW</i>	
	<i>Rs million</i>	<i>(W1)</i>	<i>Rs million</i>	<i>Elim</i>	<i>(W3)</i>	<i>trading</i>	<i>(W5)</i>	<i>Impt</i>	<i>Consol</i>
				<i>(W2)</i>		<i>(W4)</i>		<i>PPE</i>	<i>Rs million</i>
								<i>(W6)</i>	
Revenue	43,000	26,000	69,000			(6,000)			63,000
Cost of sales	(28,000)	(18,000)	(46,000)			6,000	(1,000)		(41,000)
Gross profit	15,000	8,000	23,000				(1,000)		22,000
Divi income	2,000	–	2,000	(2,000)					–
Distr costs	(2,000)	(800)	(2,800)						(2,800)
Admin exp	(4,000)	(2,200)	(6,200)		(50)			(500)	(6,750)
Finance costs	(500)	(300)	(800)						(800)
Profit before tax	10,500	4,700	15,200	(2,000)	(50)		(1,000)	(500)	11,650
Income taxes	(1,400)	(900)	(2,300)						(2,300)
Profit for the year	9,100	3,800	12,900	(2,000)	(50)		(1,000)	(500)	9,350
Reval surplus	–	2,000	2,000						2,000
Invt	200	–	200						200
TCI	9,300	5,800	15,100	(2,000)	(50)		(1,000)	(500)	11,550
<b>Profit</b>									
Owners of parent	9,100	2,280	11,380	(2,000)	(30)		(1,000)	(300)	8,050
NCI		1,520	1,520		(20)			(200)	1,300
<b>TCI</b>									
Owners of parent	9,300	3,480	12,780	(2,000)	(30)		(1,000)	(300)	9,450
NCI		2,320	2,320		(20)			(200)	2,100

**Workings**

- 1 The profit of P Co is split between the owners of the parent and the NCI in proportion to the ownership interests:

Owners of parent: Rs. 3.8m × 60% = Rs. 2.28m

NCI: Rs. 3.8m × 40% = Rs. 1.52m

The TCI of P Co is also split in proportion to the ownership interests:

Owners of parent: Rs. 5.8m × 60% = Rs. 3.48m

NCI: Rs. 5.8m × 40% = Rs. 2.32m

- 2 The dividend from P Co to C Co is eliminated against retained earnings and the NCI by:

DEBIT Dividend income Rs. 2m

CREDIT Retained earnings (SOF) Rs. 2m

- 3 The fair value adjustment of Rs. 1m is depreciated over the remaining life of the building. The amount to be charged for 20X8 is:

$$1,000,000/20 = 50,000$$

This is recorded by:

DEBIT Administrative expenses Rs. 50,000

CREDIT PPE Rs. 50,000

The administrative expense is allocated proportionately to the owners of the parent and the NCI (Rs. 30,000: Rs. 20,000)

- 4 Intra-group trading is eliminated by:

DEBIT Revenue Rs. 6m

CREDIT Cost of sales Rs. 6m

- 5 The unrealised profit is Rs. 6m  $\times$  20/120 = Rs. 1m. This is eliminated by:

DEBIT Cost of sales Rs. 1m

CREDIT Inventory Rs. 1m

The parent company is the seller and therefore the Rs. 1m cost of sale is allocated to the owners of the parent.

- 6 The goodwill impairment is recognised by:

DEBIT Administrative expense Rs. 500,000

CREDIT Goodwill Rs. 500,000

As the NCI is measured at fair value the impairment loss is allocated between owners of the parent and the NCI.

## 5 Disposal of a subsidiary



**Where a subsidiary is disposed of in an accounting period:**

- **Its results are consolidated to the date of disposal**
- **A profit or loss on disposal is calculated and reported in the consolidated statement of financial position**

All or some of the shares held in a subsidiary may be sold in an accounting period. Only a full disposal is on the KB1 syllabus, and therefore we shall concentrate on this scenario.

Where a subsidiary is sold, the impact on the consolidated financial statements is as follows:

- (a) Consolidated statement of financial position – neither the subsidiary nor any non-controlling interest is recognised at the period end. Remember that the statement of financial position is a 'snapshot in time' and if the subsidiary has been sold, then it will not be represented at all.
- (b) Consolidated statement of profit or loss and other comprehensive income
  - The results of the subsidiary are consolidated until the date of disposal. Therefore the subsidiary's results must be pro-rated in a similar way to that in the case of a mid-year acquisition (see Section 1).
  - A group profit or loss on disposal is reported.

### 5.1 Profit or loss on disposal

Two profit or loss figures are relevant on the disposal of a subsidiary: the profit or loss in the parent company's individual financial statements and a different profit or loss figure in the consolidated financial statements.

In both cases, the profit or loss is calculated as the difference between consideration received (proceeds) and carrying amount, but the carrying amount of a subsidiary is different in the parent's individual financial statements and the consolidated financial statements.

### 5.1.1 Parent company profit or loss

The parent company profit or loss is calculated as:

	Rs
Fair value of consideration received	X
Carrying amount of investment	<u>(X)</u>
Profit/loss	X/(X)

In most cases, the carrying amount of the investment is cost in the parent's statement of financial position.

### 5.1.2 Consolidated profit or loss

The consolidated profit or loss is calculated as:

		Rs
Fair value of consideration received		X
Carrying amount of subsidiary:		
Net assets at disposal date	X	
Goodwill at disposal date	X	
NCI at disposal date	<u>(X)</u>	
		<u>(X)</u>
Profit/loss		X/(X)



### 5.1.3 Example: calculation of profit or loss on disposal

P Co has owned 80% of the shares in S Co for several years, acquired originally at a cost of Rs. 180m. At the date of acquisition, the fair value of the NCI was Rs. 50m and net assets were Rs. 200m. Since acquisition, there has been no impairment of goodwill.

On 1 September 20X4, P Co disposed of its shareholding in S Co for Rs. 285m when net assets of that company were Rs. 300m.

#### Required

- (a) What profit on disposal is reported in:
- P Co's individual financial statements (assuming that the investment is carried at cost)?
  - The P Group consolidated financial statements?

**Solution**

(a) (i)

		Rs million
Proceeds		285
Cost		<u>(180)</u>
Profit		105

(ii)

	Rs million	Rs million
Proceeds		285
Net assets	300	
Goodwill (180 + 50 – 200)	30	
NCI (50 + 20% (300 – 200))	<u>(70)</u>	
Net assets disposed of		<u>(260)</u>
Profit		25

On consolidation, the parent profit on disposal of Rs. 105m must be replaced by the group profit on disposal of Rs. 25m.

In addition, the subsidiary's post-acquisition profits attributable to the owners of the parent must be credited to retained earnings. The amount is Rs.  $100\text{m} \times 80\% = \text{Rs. } 80\text{m}$ . It is no coincidence that this is the same amount as the difference between the two profit figures. In fact, group retained earnings after a disposal can either be calculated as:

Parent's retained earnings +

Share of subsidiary's profit from acquisition to disposal +

Group profit on disposal

Or

Parent's retained earnings +

Individual company profit on disposal

**QUESTION****Disposal**

Phuket Co bought 80% of the share capital of Singapore Co for Rs. 324m on 1 October 20X5. At that date, Singapore Co's retained earnings balance stood at Rs. 180m. The statements of financial position at 30 September 20X8 and the summarised statements of profit or loss to that date are given below. (There is no other comprehensive income.)

	<i>P Co</i> Rs million	<i>S Co</i> Rs million
Non-current assets	360	270
Investment in S Co	324	–
Current assets	<u>370</u>	<u>370</u>
	<u>1,054</u>	<u>640</u>
Equity		
Stated capital	540	180
Retained earnings	414	360
Current liabilities	<u>100</u>	<u>100</u>
	<u>1,054</u>	<u>640</u>
Profit before tax	153	126
Tax	<u>(45)</u>	<u>(36)</u>
Profit for the year	<u>108</u>	<u>90</u>

No entries have been made in the accounts for any of the following transactions.

Assume that profits accrue evenly throughout the year and goodwill is not impaired.

It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Ignore taxation.

### Required

**Prepare** the consolidated statement of financial position and statement of profit or loss at 30 September 20X8 if Phuket Co sells its entire holding in Singapore Co for Rs. 650m on 30 September 20X8.

## ANSWER

### CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X8

	Rs million
Non-current assets	360
Current assets (370 + 650)	<u>1,020</u>
	<u>1,380</u>
<i>Equity</i>	
Stated capital	540
Retained earnings (W2)	740
Current liabilities	<u>100</u>
	<u>1,380</u>



CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED  
30 SEPTEMBER 20X8

	Rs million
Profit before tax (153 + 126)	279
Profit on disposal (W1)	182
Tax (45 + 36)	<u>(81)</u>
	<u>380</u>
Profit attributable to:	
Owners of the parent	362
Non-controlling interest (20% × 90)	<u>18</u>
	<u>380</u>

*Workings*

1 *Profit on disposal of Jones Co*

	Rs million	Rs million
Fair value of consideration received		650
Less net assets disposed of		
Net assets	540	
Goodwill (see below)	36	
Non-controlling interest: 20% × 540	<u>(108)</u>	
	<u>576</u>	
		<u>(468)</u>
		<u>182</u>

*Note: goodwill*

	Rs million
Consideration transferred	324
NCI (20% × 360)	72
Acquired: (180 + 180)	<u>(360)</u>
	<u>36</u>

2 *Retained earnings carried forward*

	P Co Rs million	S Co Rs million
Per question/date of disposal	414	360
Add group gain on disposal (W1)	182	–
Reserves at acquisition	–	<u>(180)</u>
		<u>180</u>
Share of post-acq'n reserves up to the disposal (80% × 180)	<u>144</u>	
	<u>740</u>	

## 6 Disclosure of interests in subsidiaries



**The disclosure requirements for investments in group companies are provided by SLFRS 12 *Disclosure of interests in other entities*.**

SLFRS 12 requires an entity to disclose information that enables users to evaluate the nature of, and risks associated with, its interests in other entities and the effects of those interests on its financial position, financial performance and cash flows.

### 6.1 Significant judgements and assumptions

In respect of investments in subsidiaries, it must disclose the significant judgements and assumptions made in determining whether it has control, for example assumptions made in determining:

- That it does not control another entity even though it has more than 50% voting rights
- That it does control another entity even though it holds less than 50% of voting rights

### 6.2 Interests in subsidiaries

In respect of interests in subsidiaries, consolidated financial statements must also disclose information to enable the users of financial statements to:

(a) Understand:

- The composition of the group
- The interest that non-controlling interests have in the group's activities and cash flows

(b) Evaluate:

- The nature and extent of significant restrictions on its ability to access or use assets and settle liabilities of the group
- The nature of, and changes in, risks associated with interests in subsidiaries
- The consequences of losing control of a subsidiary during the reporting period

### **6.2.1 Interest that the NCI has in the group's activities and cash flow**

For each subsidiary with a material non-controlling interest, the following should be disclosed:

- (a) The name of the subsidiary
- (b) The principal place of business
- (c) The proportion of ownership interests held by the NCI
- (d) The proportion of voting rights held by the NCI
- (e) The profit or loss allocated to the NCI during the period
- (f) Accumulated non-controlling interests of the subsidiary at the end of the reporting period
- (g) Summarised financial information about the subsidiary

### **6.2.2 Nature and extent of significant restrictions**

An entity should disclose:

- (a) Significant restrictions on its ability to access or use the assets and settle the liabilities of the group
- (b) The nature and extent to which protective rights of the NCI can significantly restrict the entity's ability to access or use the assets and settle the liabilities of the group
- (c) The carrying amounts in the consolidated financial statements of the assets and liabilities to which those restrictions apply

### **6.2.3 Nature of risks associated with an entity's interests in subsidiaries**

An entity shall disclose:

- (a) The terms of contractual arrangements that could require a parent or its subsidiaries to provide financial support to another subsidiary
- (b) Details of any such support provided in the period where there was no contractual obligation to do so
- (c) Any current intentions to provide financial or other support to a subsidiary

### **6.2.4 Consequences of losing control of a subsidiary in the period**

An entity shall disclose the gain or loss on disposal and the line item in profit or loss in which it is recognised.



## CHAPTER ROUNDUP

- ↪ When preparing a consolidated statement of profit or loss, the basic principle is to add across the income and expenses of parent and subsidiaries.
- ↪ The NCI is allocated its share of the profit made by the subsidiary in the reporting period.
- ↪ Consolidation adjustments may include the impairment of goodwill, the elimination of intra-group trading and the elimination of unrealised profits.
- ↪ Other comprehensive income of the parent and subsidiary are added together in the same way as income and expenses. Total comprehensive income is allocated between the parent and non-controlling interest.
- ↪ Where a subsidiary is disposed of in an accounting period:
  - Its results are consolidated to the date of disposal
  - A group profit or loss on disposal is calculated and reported in the consolidated statement of profit or loss
- ↪ The disclosure requirements for investments in group companies are provided by SLFRS 12 *Disclosure of interests in other entities*.


**PROGRESS TEST**

- 1 What adjustment is required for inter-company sales?
- 2 Is an impairment of goodwill allocated to the owners of the parent or both the owners of the parent and the NCI?
- 3 Where an item of PPE has been transferred in the accounting period, how is the unrealised profit calculated?
- 4 How is a group profit on disposal of a subsidiary calculated?
- 5 P Co owns 90% of S Co. The cost of sales of the companies in the year ended 31 December 20X4 are Rs. 400m and Rs. 200m respectively. During the year, P Co sold goods to S Co for Rs. 50m achieving a profit of Rs. 10m. The goods remain in stock at the year end. What is group cost of sales?
  - A Rs. 540m
  - B Rs. 550m
  - C Rs. 560m
  - D Rs. 590m
- 6 P Co has owned 85% of the stated capital of S Co for a number of years. P Co made profit of Rs. 300m for the year ended 31 December 20X5 and S Co made Rs. 100m. Consolidated profit for the year is Rs. 390m after adjustment for an Rs. 10m goodwill impairment. NCI is measured at share of net assets. What is profit allocated to the NCI?
  - A Rs. 13.5m
  - B Rs. 15m
  - C Rs. 58.5m
  - D Rs. 85m
- 7 P Co sold its 100% shareholding in S Co in 20X4 for Rs. 700m. The shares had been acquired for Rs. 400m when the net assets of S Co were Rs. 375m. The net assets of S Co on the disposal date are Rs. 610m. What profit figure should be reported in the consolidated statement of profit or loss?
  - A Rs. 65m
  - B Rs. 90m
  - C Rs. 115m
  - D Rs. 300m

## ANSWERS TO PROGRESS TEST

- 1     DEBIT     Revenue                      Inter-company sales  
       CREDIT   Cost of sales                Inter-company sales
- 2     It depends on how the NCI is measured. Where it is measured as a proportion of net assets, a goodwill impairment is allocated to the owners of the parent; where it is measured at fair value and so some goodwill is attributable to the NCI, any loss is split between the owners of the parent and the NCI in proportion to their ownership interest.
- 3     As the profit or loss on disposal plus the difference between old and new depreciation
- 4     Proceeds – (net assets + goodwill – NCI)
- 5     The answer is **C**. Group cost of sales is Rs. 400m + Rs. 200m – Rs. 50m inter-company sales + Rs. 10m unrealised profit = Rs. 560m.
- 6     The answer is **B**. Rs. 100m × 15% = Rs. 15m  
The impairment loss is allocated to the owners of the parent only.
- 7     The answer is **A**. Proceeds 700m – net assets 610m – goodwill 25m = Rs. 65m profit.

# Associates and Joint Arrangements

## INTRODUCTION

Associates are companies in which a parent company has significant influence. This is less than the control that it has over subsidiaries, and accordingly these companies are not consolidated. Instead, they are equity accounted.

One company may have joint control of another. In this case, SLFRS 11 *Joint arrangements* applies. Some joint arrangements are accounted for in the same way as associates.

Knowledge Component			
2	Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)		
2.2	Level B	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.

3 Preparation of Financial Statements

3.1 Consolidated financial statements

- 3.1.1 Prepare consolidated financial statements (Consolidated Statement of Financial Position and Consolidated Statement of Profit or Loss and Other Comprehensive Income) involving one or two subsidiaries and an associate firm in conformity with SLFRS/LKAS, with emphasis on:
- Elimination of inter-company transactions and balances
  - Fair valuation of purchase consideration and identifiable assets and liabilities of acquired subsidiary
  - Pre- and post-acquisition profits
  - Goodwill or gain on bargain purchase of simple acquisition of a subsidiary
  - Gain/loss on disposal of a subsidiary
  - Non-controlling interest
  - Equity accounting



**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1 Associates	2.2, 3.1
2 Joint arrangements	2.2, 3.1
3 Disclosure	2.2, 3.1

**SLFRS 10, SLFRS 11 and LKAS 28 Learning objectives**

- Prepare consolidated financial statements (consolidated statement of financial position, consolidated statement of profit or loss and other comprehensive income).
- Apply and discuss the criteria used to identify a subsidiary and an associate.
- Apply appropriate procedures to be used in preparing group financial statements.
- Describe an associate entity and a joint venture arrangement.
- Explain different types of joint arrangement.
- Recognise joint control and significant influence.
- Apply equity method of accounting for investment in associate and joint ventures.
- Describe when to discontinue equity method of accounting.

**1 Associates**

LKAS 28 *Investments in associates and joint ventures* deals with identifying and accounting for an associate. The principles of equity accounting are applied.

As we saw in Chapter 21, an investment in which a parent company has significant influence is known as an associate and is equity accounted. Before considering the mechanics of equity accounting, it is important to understand what is meant by significant influence. The definition of significant influence is one of those provided in the standard.

## 1.1 Definitions



An **associate** is an entity, including an unincorporated entity such as a partnership, over which an investor has significant influence and which is neither a subsidiary nor an interest in a joint venture.

**Significant influence** is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.

**Equity method.** A method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee. The profit or loss of the investor includes the investor's share of the profit or loss of the investee.

## 1.2 Significant influence

Significant influence can be determined by the holding of voting rights (usually attached to shares) in the entity. LKAS 28 states that if an investor holds 20% or more of the voting power of the investee, it can be presumed that the investor has significant influence over the investee, **unless** it can be clearly shown that this is not the case.

Significant influence can be presumed **not** to exist if the investor holds less than 20% of the voting power of the investee, unless it can be demonstrated otherwise.

The existence of significant influence is evidenced in one or more of the following ways.

- (a) Representation on the board of directors (or equivalent) of the investee
- (b) Participation in the policy making process
- (c) Material transactions between investor and investee
- (d) Interchange of management personnel
- (e) Provision of essential technical information

## 1.3 The equity method

LKAS 28 requires that all investments in associates are accounted for in the consolidated financial statements using the equity method unless an exemption applies. LKAS 27 permits use of the equity method when accounting for investments in subsidiaries, joint ventures and associates in an investor's separate financial statements.

### 1.3.1 Exemption from application of equity method

LKAS 28 states that if an investment in an associate is classified as 'held for sale' in accordance with SLFRS 5, it should be accounted for under SLFRS 5 (see Chapter 17).

An entity is also exempt from applying the equity method in its consolidated financial statements where the following applies.

- (a) It is a parent exempt from preparing consolidated financial statements under SLFRS 10, or
- (b) All of the following apply:
  - (i) The investor is a wholly owned subsidiary or it is a partially owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method
  - (ii) The investor's securities are not publicly traded
  - (iii) It is not in the process of issuing securities in public securities markets
  - (iv) The ultimate or intermediate parent publishes consolidated financial statements that comply with International Financial Reporting Standards

### 1.3.2 Discontinuation of the equity method

The use of the equity method should be discontinued from the date that the investor ceases to have significant influence.

From that date, the investor shall account for the investment in accordance with LKAS 39/SLFRS 9. The carrying amount of the investment at the date that it ceases to be an associate is regarded as its cost on initial measurement as a financial asset under LKAS 39/SLFRS 9.

### 1.3.3 Principles of equity accounting

Under the equity method:

- (a) A single figure for investment in associates is shown in the **consolidated statement of financial position**. At the time of the acquisition, this is stated at cost. This is subsequently increased or decreased by the group's share of the total comprehensive income made in the year by the associate.
- (b) In the **consolidated statement of profit or loss and other comprehensive income**, the group share of the profit or loss of the associate is recognised together with group share of the associates other comprehensive income.

1.3.4 Coterminous accounting periods

The most recent financial statements of the associate should be used, and where practicable these should be made up to the same reporting date as the financial statements of the parent company. If this is not practicable, then the difference between the reporting date of the associate and the parent should be no more than three months and adjustments must be made to reflect transactions in this time.

1.3.5 Uniform accounting policies

Uniform accounting policies should be applied in the financial statements of the associate and parent company. Where this is not the case, the associate's accounts are adjusted.

1.4 The equity method in the consolidated financial statements

1.4.1 Consolidated statement of financial position

In the consolidated statement of financial position, 'Investment in associate' is shown as a non-current asset calculated as:

	Rs
Cost	X
Associate's retained total comprehensive income	
since acquisition × group share	$\frac{X/(X)}{X}$
Carrying amount	

1.4.2 Consolidated statement of profit or loss and other comprehensive income

In the consolidated statement of profit or loss, the associate is included as two line items:

- Share of profit (or loss) of associate
- Share of other comprehensive income of associate

The following example illustrates the accounting entries required to achieve equity accounting.



1.4.3 Example: equity accounting

On 1 July 20X3, the Purijjala Group acquired 40% of the voting shares in Abekoon Co at a cost of Rs. 300m, paid in cash. Abekoon made profits of Rs. 12m in the year ended 31 December 20X3 (which were deemed to accrue evenly throughout the year) and Rs. 25m in the year ended 31 December 20X4. In 20X4,

Abekoon Co also recognised revaluation losses in other comprehensive income of Rs. 6m.

On 1 July 20X3, the initial investment is recognised by:

DEBIT	Investment in associate	Rs. 300m
CREDIT	Cash	Rs. 300m

This entry is recognised in the parent company's own financial statements and so automatically carried through to the group financial statements when the parent and subsidiary assets are added across as part of the consolidation process.

At 31 December 20X3, 40% of the profits made by Abekoon Co in the year are recognised in the Purijjala Group financial statements by:

DEBIT	Investment in associate ( $40\% \times \text{Rs. } 12\text{m} \times 6/12\text{m}$ )	Rs. 2.4m
CREDIT	Share of profit of associate (CSPL)	Rs. 2.4m

The credit to the consolidated statement of profit or loss is accumulated in group retained earnings. The associate now has a carrying amount in the consolidated statement of financial position of Rs. 302.4m ( $300\text{m} + 2.4\text{m}$ ).

At 31 December 20X4, 40% of the profits made by Abekoon Co in the year and 40% of the expense recognised in other comprehensive income by Abekoon Co in the year are recognised in the Purijjala Group financial statements by:

DEBIT	Investment in associate ( $40\% \times (\text{Rs. } 25\text{m} - \text{Rs. } 6\text{m})$ )	Rs. 7.6m
DEBIT	Other comprehensive income from associate ( $40\% \times \text{Rs. } 6\text{m}$ )	Rs. 2.4m
CREDIT	Share of profit of associate ( $40\% \times \text{Rs. } 25\text{m}$ )	Rs. 10m

The credit to the consolidated statement of profit or loss is accumulated in group retained earnings; the debit to other comprehensive income is accumulated in the group revaluation surplus. The associate now has a carrying amount in the consolidated statement of financial position of Rs. 307.6m ( $302.4\text{m} + 7.6\text{m} - \text{Rs. } 2.4\text{m}$ ).

Extracts from the consolidated financial statements are as follows:

<b>Consolidated statement of financial position</b>	<b>20X4</b>	<b>20X3</b>
	Rs million	Rs million
Investment in associate	307.6	302.4

<b>Consolidated statement of profit or loss and other comprehensive income</b>	<b>20X4</b>	<b>20X3</b>
	Rs million	Rs million
Share of profits of associate	10	2.4
Share of other comprehensive income of associate	(2.4)	-

### 1.4.4 Losses in associates

In the last example, we saw losses (other comprehensive income) being made by the associate. The group share of losses made by an associate reduce the carrying amount of the associate in the consolidated statement of financial position until such time as the carrying amount is reduced to nil. After this, additional losses are provided for as a liability, recognised to the extent that the parent has legal or constructive obligations to make or has made payments on behalf of the associate.

If the associate later returns to profit, the parent resumes recognising its share of profits only after they equal the share of losses not recognised.

### 1.4.5 Dividends from associates

Where an associate has declared or paid a dividend, this reduces the carrying amount of the investment in associate to ensure that the investment is calculated as cost plus **retained** total comprehensive income.



### 1.4.6 Example: dividend from associate

On 1 January 20X3, Pacific Plants Group acquired 25% of Atlantic Aquatics Co at a cost of Rs. 150m. Atlantic Aquatics made profits in the year ended 31 December 20X3 of Rs. 30m and no other comprehensive income. On 17 July 20X3, Atlantic Aquatics Co declared an interim dividend of Rs. 5m.

On 1 January 20X3, the initial investment is recognised by:

DEBIT	Investment in associate	Rs. 150m
CREDIT	Cash	Rs. 150m

As before, this entry is made in the parent company's individual financial statements and automatically carried across to the consolidated financial statements.

The parent company records the dividend income in July 20X3 by:

DEBIT	Cash (25% × 5m)	Rs. 1.25m
CREDIT	Investment income	Rs. 1.25m

On consolidation, the investment income is automatically added into the consolidated statement of profit and loss. It must, however, be eliminated and replaced with the group share of the associate's profits of  $25\% \times \text{Rs. } 30\text{m} = \text{Rs. } 7.5\text{m}$  by:

DEBIT	Investment in associate (CSOFP)	Rs. 6.25m
DEBIT	Investment income (CSPL)	Rs. 1.25m
CREDIT	Share of profits of associate	Rs. 7.5m

Therefore, only the retained profit is added to the carrying amount of the investment in associate, which becomes Rs. 150m + Rs. 6.25m = Rs. 156.25m. The other Rs. 1.25m is represented by cash in the consolidated statement of financial position (or an asset that the dividend received has been spent on).

#### 1.4.7 Allocation of cost price to net assets acquired

As we have seen, an associate is always carried at cost when initially recognised. Despite this, on acquisition, the consideration paid is notionally allocated to the fair value of the net assets acquired.

- (a) Where the cost of the investment exceeds the fair value of net assets acquired, notional goodwill exists within the carrying amount of the investment in the statement of financial position. This is not recognised separately as goodwill and is not amortised.
- (b) Where the cost of the investment is less than the fair value of net assets acquired, the difference is included as income in the determination of the investor's share of the associate's profit or loss in the period in which the investment is acquired.

### 1.5 Consolidation adjustments

An associate is not part of the single economic entity that forms a group. As a result, there is no need to eliminate intra-group transactions when equity accounting.

Unrealised profits relating to inter-company sales and transfers of assets do, however, require adjustment. These are referred to by LKAS 28 as upstream and downstream transactions and are dealt with as follows.

#### 1.5.1 Upstream transactions

Upstream transactions are sales from the associate to a group company (parent or subsidiary).

The **group share** (A%) of unrealised profits or losses resulting from upstream transactions is eliminated by:

DEBIT	Cost of sales (parent or subsidiary)	Unrealised profit × A%
CREDIT	Group inventory	Unrealised profit × A%

#### 1.5.2 Downstream transactions

Downstream transactions are sales from a group company (parent or subsidiary) to the associate.

The **group share** (A%) of unrealised profits or losses resulting from downstream transactions is eliminated by:

DEBIT	Cost of sales (parent or subsidiary)	Unrealised profit × A%
CREDIT	Investment in associate	Unrealised profit × A%



**QUESTION** Upstream and downstream transactions

Polgolla Co, a parent with subsidiaries, holds 25% of the equity shares in Alwatta Co. During the year, Alwatta Co makes sales of Rs. 1,000,000 to Polgolla Co at cost plus a 25% mark-up. At the year end, Polgolla Co has all these goods still in inventories. Polgolla and its subsidiaries have a consolidated year-end inventory balance of Rs. 13m and Alwatta of Rs. 6m.

**Required**

**Prepare** the adjustment required on consolidation and **calculate** the reported group inventory balance.

**ANSWER**

Alwatta Co has made an unrealised profit of Rs. 200,000 (1,000,000 × 25/125) on its sales to Polgolla. The group's share (25%) of this must be eliminated:

DEBIT	Cost of sales (CASPL)	Rs. 50,000
CREDIT	Inventories (CSOFP)	Rs. 50,000

Reported group inventories is therefore Rs. 13m – Rs. 50,000 = Rs. 12,950,000. Remember that an associate company's inventories are not added across to form part of consolidated inventories.

**1.6 Impairment losses**

An investment in an associate is a financial asset as defined by LKAS 39. That standard provides a list of indicators that a financial asset may be impaired.

Any impairment loss in respect of an associate is recognised in accordance with LKAS 36 and reduces the carrying amount of the associate:

	Rs
Cost	
Associate's retained total comprehensive income since acquisition × group share	X/(X)
Impairment losses since acquisition	<u>(X)</u>
Carrying amount	<u>X/0</u>



## 1.7 Investments in associates in the separate financial statements of the investor

An investment in an associate is accounted for in the separate financial statements of the investor either:

- (a) At cost, or
- (b) In accordance with LKAS 39/SLFRS 9 (at fair value)

This treatment applies whether or not consolidated financial statements are prepared.



### QUESTION

### Equity accounting 1

On 1 January 20X6, the net tangible assets of Alahakoon Co amount to Rs. 220m, financed by Rs. 100m stated capital and retained earnings of Rs. 120m. Padupola Co, a company with subsidiaries, acquires 30% of the shares in Alahakoon Co for Rs. 75m. During the year ended 31 December 20X6, Alahakoon Co's profit after tax is Rs. 30m, from which dividends of Rs. 12m are paid.

### Required

**Record** how Padupola Co's investment in Alahakoon Co would appear in the consolidated statement of financial position at 31 December 20X6.

### ANSWER

#### CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X6 (EXTRACT)

	Rs'000
Non-current assets	
Investment in associated company	
Cost	75,000
Group share of post-acquisition retained earnings (30% × Rs. 18m)	5,400
	<u>80,400</u>



## QUESTION

## Equity accounting 2

The statements of financial position of J Co and its investee companies, P Co and S Co, at 31 December 20X5 are shown below.

### STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	<i>J Co</i> Rs million	<i>P Co</i> Rs million	<i>S Co</i> Rs million
<i>Non-current assets</i>			
Freehold property	1,950	1,250	500
Plant and machinery	795	375	285
Investments	<u>1,500</u>	<u>–</u>	<u>–</u>
	<u>4,245</u>	<u>1,625</u>	<u>785</u>
<i>Current assets</i>			
Inventory	575	300	265
Trade receivables	330	290	370
Cash	<u>50</u>	<u>120</u>	<u>20</u>
	<u>955</u>	<u>710</u>	<u>655</u>
Total assets	<u>5,200</u>	<u>2,335</u>	<u>1,440</u>
<i>Equity and liabilities</i>			
<i>Equity</i>			
Stated capital	2,000	1,000	750
Retained earnings	<u>1,460</u>	<u>885</u>	<u>390</u>
	<u>3,460</u>	<u>1,885</u>	<u>1,140</u>
<i>Non-current liabilities</i>			
12% loan stock	500	100	
<i>Current liabilities</i>			
Trade payables	680	350	300
Bank overdraft	<u>560</u>	<u>–</u>	<u>–</u>
	<u>1,240</u>	<u>350</u>	<u>300</u>
Total equity and liabilities	<u>5,200</u>	<u>2,335</u>	<u>1,440</u>

Additional information:

- J Co acquired 600,000 of the 1 million ordinary shares in P Co on 1 January 20X0 for Rs. 1,000m when the retained earnings of P Co were Rs. 200m.
- At the date of acquisition of P Co, the fair value of its freehold property was considered to be Rs. 400m greater than its value in P Co's statement of financial position. P Co had acquired the property in January 20W0 and the buildings element (comprising 50% of the total value) is depreciated on cost over 50 years.
- J Co acquired 225,000 of the 750,000 ordinary shares in S Co on 1 January 20X4 for Rs. 500m when the retained earnings of S Co were Rs. 150m.

- (d) P Co manufactures a component used by both J Co and S Co. Transfers are made by P Co at cost plus 25%. J Co held Rs. 100m inventory of these components at 31 December 20X5. In the same period, J Co sold goods to S Co of which S Co had Rs. 80m in inventory at 31 December 20X5. J Co had marked these goods up by 25%.
- (e) The goodwill in P Co is impaired and should be fully written off. An impairment loss of Rs. 92m is to be recognised on the investment in S Co.
- (f) The non-controlling interest is measured at fair value. P Co shares were trading at Rs. 1,600 just prior to the acquisition by J Co.

### Required

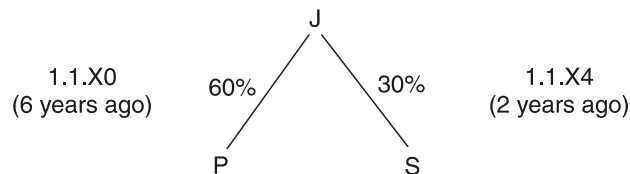
**Prepare**, in a format suitable for inclusion in the annual report of the J Group, the consolidated statement of financial position at 31 December 20X5.

## ANSWER

### J GROUP CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	Rs million
<i>Non-current assets</i>	
Freehold property (1,950 + 1,250 + 400 (W2) – 30 (W4))	3,570.00
Plant and machinery (795 + 375)	1,170.00
Investments (1,500 – 1,000 (W2) – 500 (W7))	
Goodwill (40 (W2) – 40 (W3))	
Investment in associate (500 (W7i) + 72 (W7ii) – 4.8 (W7iii) – 92 (W7iv))	<u>475.20</u>
	<u>5,215.20</u>
<i>Current assets</i>	
Inventory (575 + 300 – 20(W6))	855.00
Receivables (330 + 290)	620.00
Cash (50 + 120)	<u>170.00</u>
	<u>1,645.00</u>
Total assets	<u><u>6,860.20</u></u>
<i>Equity and liabilities</i>	
<i>Equity</i>	
Stated capital (2,000 + 1,000 – 1,000 (W2))	2,000.00
Retained earnings (1,460 + 885 – 200 (W2) – 24 (W3) – 18 (W4) – 274 (W5) – 12 (W6) + 72 (W7ii) – 4.8 (W7iii) – 92 (W7iv))	<u>1,792.20</u>
	3,792.20
Non-controlling interest (640 (W2) – 16 (W3) – 12 (W4) + 274 (W5) – 8 (W6))	<u>878.00</u>
	4,670.20

	Rs million
<i>Non-current liabilities</i>	
12% loan stock (500 + 100)	600.00
<i>Current liabilities</i> (680 + 560 + 350)	<u>1,590.00</u>
Total equity and liabilities	<u><u>6,860.20</u></u>

*Workings*1 *Group structure*2 *Goodwill on acquisition of P Co*

	Rs million	Rs million
Consideration transferred		1,000
Non-controlling interest (400 × 1600)		640
Net assets acquired		
Share capital	1,000	
Retained earnings	200	
Fair value adjustment	<u>400</u>	
		<u>(1,600)</u>
Goodwill at acquisition		40

The acquisition consolidation journal is therefore:

DEBIT	Goodwill	Rs. 40m
DEBIT	Share capital	Rs. 1,000m
DEBIT	Retained earnings	Rs. 200m
DEBIT	Freehold property	Rs. 400m
CREDIT	Investment	Rs. 1,000m
CREDIT	NCI	Rs. 640m

3 *Goodwill impairment*

The goodwill is fully impaired; this is recorded by;

DEBIT	Retained earnings	Rs. 24m
DEBIT	NCI	Rs. 16m
CREDIT	Goodwill	Rs. 40m

4 *Depreciation of fair value adjustment*

Additional depreciation  $(400 \times 50\% \div 40) \times 6 \text{ years} = \text{Rs. } 30\text{m}$

This is recorded by:

DEBIT	Retained earnings (60%)	Rs. 18m
DEBIT	NCI (40%)	Rs. 12m
CREDIT	Freehold property	Rs. 30m

5 *Profits of NCI since acquisition*

NCI share of post-acquisition retained earnings in P is  $((885 - 200) \times 40\%)$  274.00

This is recorded by:

DEBIT	Retained earnings	Rs. 274m
CREDIT	NCI	Rs. 274m

6 *Unrealised profit*

On sales by P to J (parent co)  $100 \times 25/125$  20.0

This is recorded by:

DEBIT	Retained earnings (60%)	Rs. 12m
DEBIT	NCI (40%)	Rs. 8m
CREDIT	Inventory	Rs. 20m

7 *Investment in associate*

(i) The cost of the investment is transferred to 'investments in associates' by:

DEBIT	Investment in associate	Rs. 500m
CREDIT	Investments	Rs. 500m

(ii) Post acquisition profits of  $(390 - 150) \times 30\% = \text{Rs. } 72\text{m}$  are allocated to the investment in associate by:

DEBIT	Investment in associate	Rs. 72m
CREDIT	Retained earnings	Rs. 72m

(iii) The group share of the unrealised profit made on sales by J to S is  $80 \times 25/125 \times 30\% = \text{Rs. } 4.8\text{m}$ . This is recorded by:

DEBIT	Retained earnings	Rs. 4.8m
CREDIT	Investment in associate	Rs. 4.8m

(iv) The impairment loss of Rs. 92m is recognised by:

DEBIT	Retained earnings	Rs. 92m
CREDIT	Investment in associate	Rs. 92m

## 2 Joint arrangements



**Joint arrangements are classified as either joint operations or joint ventures depending on the rights and obligations of the parties to the arrangement.**

SLFRS 11 *Joint arrangements* provides the accounting treatment applicable to entities over which an investor has joint control.

### 2.1 Definitions



A **joint arrangement** is an arrangement of which two or more parties have joint control.

**Joint control** is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

A **joint operation** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.

A **joint venture** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

A joint arrangement that is not structured through a separate entity is always a joint operation; a joint arrangement that is structured through a separate entity may be a joint operation or a joint venture.

SLFRS 11 summarises the basic issues that underlie the classifications in the following diagram.

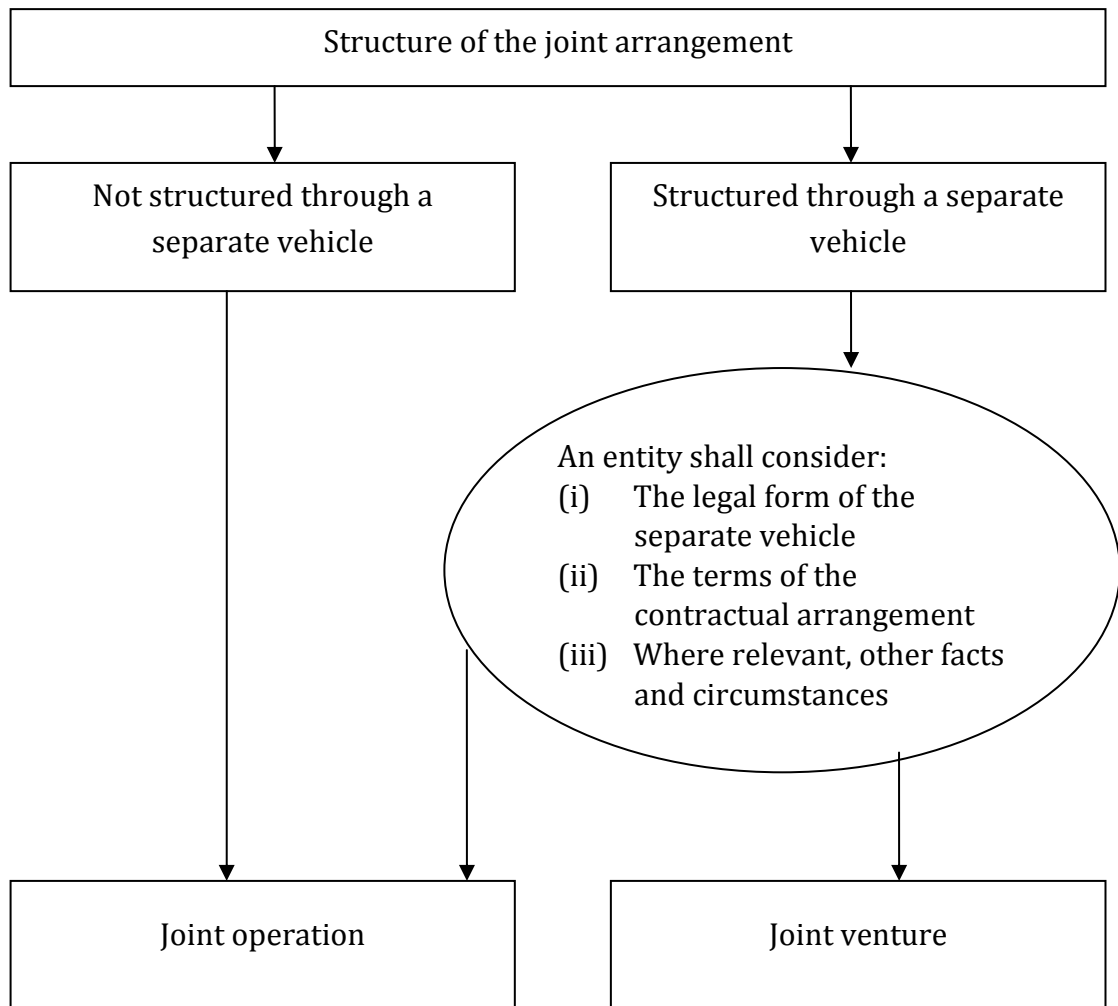


Figure 24.1

### 2.1.1 Contractual arrangement

The existence of a contractual agreement distinguishes a joint arrangement from an investment in an associate. **If there is no contractual arrangement, then a joint arrangement does not exist.**

Evidence of a contractual arrangement could be in one of several forms.

- Contract between the parties
- Minutes of discussion between the parties
- Incorporation in the articles or by-laws of the joint venture

The contractual arrangement is usually in writing, whatever its form, and it will deal with the following issues surrounding the joint venture.

- Its activity, duration and reporting obligations
- The appointment of its board of directors (or equivalent) and the voting rights of the parties
- Capital contributions to it by the parties
- How its output, income, expenses or results are shared between the parties

It is the contractual arrangement that establishes **joint control** over the joint venture, so that no single party can control the activity of the joint venture on its own.

The terms of the contractual arrangement are key to deciding whether the arrangement is a joint venture or joint operation. SLFRS 11 includes a table of issues to consider and explains the influence of a range of points that could be included in the contract. The table is summarised below.

	Joint operation	Joint venture
<b>The terms of the contractual arrangement</b>	The parties to the joint arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.	The parties to the joint arrangement have rights to the <b>net assets</b> of the arrangement (ie it is the separate vehicle, not the parties, that has rights to the assets, and obligations for the liabilities).
<b>Rights to assets</b>	The parties to the joint arrangement share all interests (eg rights, title or ownership) in the assets relating to the arrangement in a specified proportion (eg in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement's assets. The parties have no interests (ie no rights, title or ownership) in the assets of the arrangement.



	Joint operation	Joint venture
<b>Obligations for liabilities</b>	The parties share all liabilities, obligations, costs and expenses in a specified proportion (eg in proportion to their ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	<p>The joint arrangement is liable for the debts and obligations of the arrangement.</p> <p>The parties are liable to the arrangement only to the extent of their respective:</p> <ul style="list-style-type: none"> <li>• Investments in the arrangement</li> <li>• Obligations to contribute any unpaid or additional capital to the arrangement, or</li> <li>• Both</li> </ul>
	The parties to the joint arrangement are liable for claims by third parties.	Creditors of the joint arrangement do not have rights of recourse against any party.
<b>Revenues, expenses, profit or loss</b>	The contractual arrangement establishes the allocation of revenues and expenses on the basis of the relative performance of each party to the joint arrangement. For example, the contractual arrangement might establish that revenues and expenses are allocated on the basis of the capacity that each party uses in a plant operated jointly.	The contractual arrangement establishes each party's share in the profit or loss relating to the activities of the arrangement.
<b>Guarantees</b>	The provision of guarantees to third parties, or the commitment by the parties to provide them, does not, by itself, determine that the joint arrangement is a joint operation.	

**QUESTION****Joint arrangements**

Two real estate companies (the parties) set up a separate vehicle (Supermall) for the purpose of acquiring and operating a shopping centre. The contractual arrangement between the parties establishes joint control of the activities that are conducted in Supermall. The main feature of Supermall's legal form is that the entity, not the parties, has rights to the assets, and obligations for the liabilities, relating to the arrangement. These activities include the rental of the retail units, managing the car park, maintaining the centre and its equipment, such as lifts, and building the reputation and customer base for the centre as a whole.

The terms of the contractual arrangement are such that:

- (a) Supermall owns the shopping centre. The contractual arrangement does not specify that the parties have rights to the shopping centre.
- (b) The parties are not liable in respect of the debts, liabilities or obligations of Supermall. If Supermall is unable to pay any of its debts or other liabilities or to discharge its obligations to third parties, the liability of each party to any third party will be limited to the unpaid amount of that party's capital contribution.
- (c) The parties have the right to sell or pledge their interests in Supermall.
- (d) Each party receives a share of the income from operating the shopping centre (which is the rental income net of the operating costs) in accordance with its interest in Supermall.

**Required**

**Explain** how Supermall should be classified in accordance with SLFRS 11 *Joint arrangements*.

**ANSWER**

Supermall has been set up as a separate vehicle. As such, it could be either a joint operation or joint venture, so other facts must be considered.

There are no facts that suggest that the two real estate companies have rights to substantially all the benefits of the assets of Supermall nor an obligation for its liabilities.

Each party's liability is limited to any unpaid capital contribution.

As a result, each party has an interest in the net assets of Supermall and should account for it as a joint venture using the equity method.

## 2.2 Accounting for a joint operation

SLFRS 11 requires that a joint operator recognises line by line the following in relation to its interest in a joint operation:

- (a) Its assets, including its share of any jointly held assets
- (b) Its liabilities, including its share of any jointly incurred liabilities
- (c) Its revenue from the sale of its share of the output arising from the joint operation
- (d) Its share of the revenue from the sale of the output by the joint operation
- (e) Its expenses, including its share of any expenses incurred jointly

This treatment is applicable in both the separate and consolidated financial statements of the joint operator.



### QUESTION

### Joint operations

**Describe** an example of a joint operation.

### ANSWER

SLFRS 11 gives examples in the oil, gas and mineral extraction industries. In such industries, companies may, say, jointly control and operate on oil or gas pipeline. Each company transports its own products down the pipeline and pays an agreed proportion of the expenses of operating the pipeline (perhaps based on volume). In this case, the parties have rights to assets (such as exploration permits and the oil or gas produced by the activities).

A further example is a property that is jointly controlled, each joint operator taking a share of the rental income and bearing a portion of the expense.

## 2.3 Accounting for a joint venture

SLFRS 11 requires that a joint venture is equity accounted in the same way as an associate.

The **consolidated statement of financial position** is prepared by:

- Including the interest in the joint venture at cost plus share of post-acquisition total comprehensive income
- Including the group share of the post-acquisition total comprehensive income in group reserves

The **consolidated statement of profit or loss and other comprehensive income** will include:

- The group share of the joint venture's profit or loss
- The group share of the joint venture's other comprehensive income

The use of the equity method should be **discontinued** from the date on which the joint venturer ceases to have joint control over, or have significant influence over, a joint venture.

### 2.3.1 Transactions between a joint venture and a joint venturer

#### Upstream transactions

A joint venturer may sell or contribute assets to a joint venture so making a profit or loss. Any such gain or loss should, however, only be recognised to the extent that it reflects the substance of the transaction.

Therefore:

- Only the **gain** attributable to the interest of the other joint venturers should be recognised in the financial statements.
- The full amount of any **loss** should be recognised when the transaction shows evidence that the net realisable value of current assets is less than cost, or that there is an impairment loss.

#### Downstream transactions

When a joint venturer purchases assets from a joint venture, the joint venturer should not recognise its share of the profit made by the joint venture on the transaction in question until it resells the assets to an independent third party, ie until the profit is realised.

Losses should be treated in the same way, **except** losses should be recognised immediately if they represent a reduction in the net realisable value of current assets, or a permanent decline in the carrying amount of non-current assets.

### 3 Disclosure



**The disclosure requirements for investments in associates and joint ventures are provided by SLFRS 12 *Disclosure of interests in other entities*.**

SLFRS 12 requires an entity to disclose information that enables users to evaluate the nature of, and risks associated with, its interests in other entities and the effects of those interests on its financial position, financial performance and cash flows.

It must disclose the significant judgements and assumptions made in:

- Determining the nature of its interest in another entity or arrangements (ie whether the investor has control, joint control or significant influence)
- Determining (in the case of a joint arrangement) whether the joint arrangement is a joint operation or joint venture

It must also disclose information to enable the users of financial statements to evaluate:

- The nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with other investors.
- The nature of, and changes in, risks associated with interests in joint ventures and associates.

#### **3.1 Nature extent and financial effects of interests in joint arrangements and associates**

For each joint arrangement and associate that is material to the reporting entity, the following should be disclosed:

- (a) The name of the joint arrangement or associate
- (b) The nature of the entity's relationship with the joint arrangement or associate
- (c) The principal place of business/country of incorporation of the joint arrangement or associate
- (d) The proportion of ownership interest held by the entity/proportion of voting rights held

For each joint venture and associate that is material to the reporting entity, the following should be disclosed:

- (a) Whether the investment in the joint venture or associate is measured using equity method or fair value
- (b) Summarised financial information about the joint venture or associate
- (c) The fair value of the investment in the joint venture or associate (where the equity method is applied)

### **3.2 Nature of, and changes in, risks associated with interests in joint ventures and associates**

An entity should disclose:

- (a) Commitments that it has relating to its **joint ventures** separately from the amount of other commitments
- (b) Contingent liabilities incurred relating to its interests in joint ventures or **associates**, separately from the amount of other contingent liabilities.



## CHAPTER ROUNDUP

- ↪ LKAS 28 *Investments in associates and joint ventures* deals with identifying and accounting for an associate. The principles of equity accounting are applied.
- ↪ **Joint arrangements are classified as either joint operations or joint ventures depending on the rights and obligations of the parties to the arrangement.**
- ↪ The disclosure requirements for investments in associates and joint ventures are provided by SLFRS 12 *Disclosure of interests in other entities*.


**PROGRESS TEST**

- 1 Define an associate.
- 2 How should associates be accounted for in the separate financial statements of the investor?
- 3 What is the effect of the equity method on the consolidated statement of profit or loss and other comprehensive income and statement of financial position?
- 4 The A group acquires 35% of the shares in B company on 1 July 20X4 at a cost of Rs. 120m. The profits of B company in the year ended 31 December 20X4 were Rs. 50m, and the company also revalued land from its cost of Rs. 6m to market value of Rs. 18m on 1 January 20X4. After the acquisition, B company sold goods to an A group company recording a profit of Rs. 3m. Half of these goods remained in stock at the year end. What is the carrying amount of B company in the A group statement of financial position at 31 December 20X4?
  - A Rs. 127.25m
  - B Rs. 128.75m
  - C Rs. 140.2m
  - D Rs. 141.7m
- 5 Which of the following statements is/are true?
  - 1 Significant influence is presumed to exist where 50% or less voting shares are held by an investor.
  - 2 Joint control exists where two or more investors each have equal shareholdings
  - A 1 only
  - B 2 only
  - C Neither
  - D Both
- 6 Rupasinghe Retail PLC has joint control with another party over Dunuwila Stores (Pvt) Ltd such that Rupasinghe Retail has rights to 40% of the net assets of Dunuwila Stores. How does Rupasinghe Retail account for Dunuwila Stores in its consolidated financial statements?
  - A Consolidates the investment
  - B Carries the investment at cost and recognises dividend income
  - C Equity accounts for the investment
  - D Recognises its share of Dunuwila Stores' assets, liabilities, revenue and expenses on a line-by-line basis



## ANSWERS TO PROGRESS TEST

- 1 An entity, including an unincorporated entity such as a partnership, over which an investor has significant influence and which is neither a subsidiary nor an interest in a joint venture.
- 2 Either at cost or in accordance with LKAS 39/SLFRS 9.
- 3 In the CSPL, there is a line item showing the group share of the associate's profit for the year and a second line item showing group share of the associate's other comprehensive income in the year. In the CSOFP, the investment in associate is included as a non-current asset.
- 4 The answer is **B**.

	Rs million
Cost	120
Share of post-acquisition profits	
Rs. 50m × 35% × 6/12m	8.75
	128.75

- The revaluation surplus arose pre-acquisition
  - The unrealised profit is the result of an upstream transaction and so does not affect the carrying amount of the associate
- 5 The answer is **C**. Significant influence is presumed to exist where an investor holds between 20% and 50% of voting shares.  
  
Joint control exists where there is a contractually agreed sharing of control of an arrangement. This exists where the relevant activities require the unanimous consent of the parties sharing control. It does not require all parties to have equal shareholdings.
  - 6 The answer is **C**. Dunuwila Stores is a joint arrangement of Rupasinghe Retail.



# Statements of Cash Flows

## INTRODUCTION

This chapter revises LKAS 7 *Statement of cash flows*, which was introduced at the KE1 level.

Knowledge Component			
2	Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)		
2.1	Level A	2.1.1	Advise on the application of Sri Lanka Accounting Standards in solving complicated matters.
		2.1.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in conformity with Sri Lanka Accounting Standards.
		2.1.3	Evaluate the impact of application of different accounting treatments.
		2.1.4	Propose appropriate accounting policies to be selected in different circumstances.
		2.1.5	Evaluate the impact of use of different expert inputs to financial reporting.
		2.1.6	Advise on the appropriate application and selection of accounting/reporting options given under standards.
		2.1.7	Design the appropriate disclosures to be made in the financial statements.

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1	Introduction and definitions	2.1
2	Format of a statement of cash flows	2.1
3	Preparation of a statement of cash flows	2.1
4	Disclosure	2.1

**LKAS 7 Learning objectives**

- Explain the benefit of cash flow information.
- Explain the concept of operating activities, investing activities and financial activities, non-cash transactions.
- Compile a cash flow statement in compliance with the standard.
- Outline components of cash equivalents and disclosure requirements.

**1 Introduction and definitions**

**LKAS 1 requires that a statement of cash flows is presented in a complete set of financial statements. LKAS 7 *Statements of cash flows* provides guidance on the format and preparation.**

**1.1 Objective of LKAS 7**

The aim of LKAS 7 is to provide information to users of financial statements about the ability of an entity to generate cash and cash equivalents, as well as indicating the cash needs of the entity. The statement of cash flows provides historical information about cash and cash equivalents, classifying cash flows between operating, investing and financing activities.

**1.2 Scope**

A statement of cash flows should be presented as an integral part of the financial statements of an entity. All types of entity can provide useful information about cash flows as the need for cash is universal, whatever the nature of their revenue-producing activities. Therefore, all entities are required by the Standard to produce a statement of cash flows.

### 1.3 Benefits of cash flow information

The use of statements of cash flows is very much in conjunction with the rest of the financial statements. Users can gain further appreciation of the change in net assets, financial position (liquidity and solvency) and the ability of an entity to adapt to changing circumstances by adjusting the amount and timing of cash flows.

The benefits of cash flow accounting are as follows.

- (a) Survival in business depends on the ability to generate cash. Cash flow accounting directs attention towards this critical issue.
- (b) Cash flow is more comprehensive and factual than profit, which is dependent on accounting conventions and concepts.
- (c) Creditors of the business (both long and short term) are more interested in the ability of an entity to repay them than in its profitability. Whereas profits might indicate that cash is likely to be available, cash flow accounting gives clearer information.
- (d) Cash flow reporting provides a better means of comparing the results of different companies than traditional profit reporting.
- (e) Cash flow reporting satisfies the needs of all users better.
  - (i) For management, it provides the sort of information on which decisions should be taken (in management accounting, relevant costs to a decision are future cash flows). Traditional profit accounting does not help with decision making.
  - (ii) For shareholders and auditors, cash flow accounting can provide a satisfactory basis for stewardship accounting.
  - (iii) As described previously, the information needs of creditors and employees will be better served by cash flow accounting.
- (f) Cash flow forecasts are easier to prepare, as well as more useful, than profit forecasts.
- (g) They can, in some respects, be audited more easily than accounts based on the accruals concept.
- (h) The accruals concept is confusing, and cash flows are more easily understood.
- (i) Cash flow information can be both retrospective, and also include a forecast for the future. This is of great information value to all users of accounting information.

- (j) Cash flow information of a historical nature can be used as an indicator of the amount, timing and certainty of future cash flows.
- (k) Forecasts can subsequently be monitored by the publication of variance statements which compare actual cash flows against the forecast.

## 1.4 Definitions

LKAS 7 provides the following definitions.



- **Cash** comprises cash on hand and demand deposits.
- **Cash equivalents** are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.
- **Cash flows** are inflows and outflows of cash and cash equivalents.
- **Operating activities** are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.
- **Investing activities** are the acquisition and disposal of non-current assets and other investments not included in cash equivalents.
- **Financing activities** are activities that result in changes in the size and composition of the equity capital and borrowings of the entity.

### 1.4.1 Cash and cash equivalents

The Standard expands on the definition of cash equivalents: cash equivalents are not held for investment or other long-term purposes, but to meet short-term cash commitments. They are required to:

- Be convertible to a known amount of cash and therefore their maturity date is normally three months from their acquisition date
- Be subject to only an insignificant risk of changes in value

Cash equivalents	Not cash equivalents
<ul style="list-style-type: none"> <li>• Deposits available on demand</li> <li>• Short-term government bonds</li> <li>• Treasury bills</li> <li>• Money market holdings</li> <li>• Preference share investments acquired within a short period of maturity and with a specified redemption date</li> <li>• Bank overdrafts repayable on demand and treated as part of an entity's cash management system</li> </ul>	<ul style="list-style-type: none"> <li>• Deposits with a fixed maturity of more than three months</li> <li>• Amounts held by banks as security ('pledged deposits')</li> <li>• Equity investments</li> <li>• Preference share investments and bank overdrafts other than those qualifying as cash equivalents</li> <li>• Loans and other borrowings</li> </ul>

## 2 Format of a statement of cash flows



**LKAS 7 requires that cash flows are classified as cash flows from operating, investing and financing activities.**

### 2.1 Presentation of a statement of cash flows

LKAS 7 requires statements of cash flows to report cash flows during the period classified by operating, investing and financing activities.

The manner of presentation of cash flows from operating, investing and financing activities depends on the nature of the entity. By classifying cash flows between different activities in this way, users can see the impact on cash and cash equivalents of each one, and their relationships with each other.

#### 2.1.1 Operating activities

This part of the statement of cash flows shows the cash generated by day-to-day operations. Cash flows include:

- Cash receipts from the sale of goods and the rendering of services
- Cash receipts from royalties, fees, commissions and other revenue
- Cash payments to suppliers for goods and services
- Cash payments to and on behalf of employees

These cash flows are sustainable; ie, assuming that current trading levels continue, they will exist in future years. A business will therefore look for strong cash

inflows in this part of the statement of cash flows in order to meet cash commitments such as interest and tax payments.

### 2.1.2 Investing activities

The cash flows classified under this heading show the extent of new investment in assets that will generate future profit and cash flows and the proceeds from the sale of such assets. Cash flows arising from investing activities include:

- (a) Cash payments to acquire property, plant and equipment, intangibles and other non-current assets, including those relating to capitalised development costs and self-constructed property, plant and equipment
- (b) Cash receipts from sales of property, plant and equipment, intangibles and other non-current assets
- (c) Cash payments to acquire shares or debentures of other entities
- (d) Cash receipts from sales of shares or debentures of other entities
- (e) Cash advances and loans made to other parties
- (f) Cash receipts from the repayment of advances and loans made to other parties

### 2.1.3 Financing activities

This section of the statement of cash flows shows the share of cash received from and paid to capital providers of an entity during the period. This is an indicator of likely future interest and dividend payments. The following are examples of cash flows that might arise under these headings.

- (a) Cash proceeds from issuing shares
- (b) Cash payments to owners to acquire or redeem shares of the enterprise
- (c) Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short- or long-term borrowings
- (d) Cash repayments of amounts borrowed

## 2.2 Classification of cash flows

Some cash flows could conceivably fall within cash flows from operating activities or cash flows from investing activities or cash flows from financing activities. Such cash flows include interest and dividends:

- Interest paid should be classified as an operating cash flow or a financing cash flow.



- Interest received and dividends received should be classified as operating cash flows or, more usually, as investing cash flows.
- Dividends paid by the entity should be classified as an operating cash flow, so that users can assess the ability of an entity to pay dividends out of operating cash flows, or more usually, as a financing cash flow, showing the cost of obtaining financial resources.

Each should be classified in a consistent manner from period to period.

### 2.2.1 Cash flows from taxes

Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities **unless** they can be specifically identified with financing and investing activities.

Taxation cash flows are often difficult to match to the originating underlying transaction, so most of the time, all tax cash flows are classified as arising from operating activities.

## 2.3 Format of a statement of cash flows

The following format of a statement of cash flows is taken from LKAS 7.

### STATEMENT OF CASH FLOWS

YEAR ENDED 31 DECEMBER 20X7

	Rs million	Rs million
<b><i>Cash flows from operating activities:</i></b>		
Cash generated from operations	2,730	
Interest paid	(270)	
Income taxes paid	<u>(900)</u>	
<i>Net cash from operating activities</i>		1,560
<b><i>Cash flows from investing activities:</i></b>		
Purchase of property, plant and equipment	(900)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	<u>200</u>	
<i>Net cash used in investing activities</i>		(480)
<b><i>Cash flows from financing activities:</i></b>		
Proceeds from issue of stated capital	250	
Proceeds from long-term borrowings	250	
Dividends paid	<u>(1,290)</u>	
<i>Net cash used in financing activities</i>		<u>(790)</u>
<i>Net increase in cash and cash equivalents</i>		290
<i>Cash and cash equivalents at beginning of period</i>		<u>120</u>
<i>Cash and cash equivalents at end of period</i>		<u><u>410</u></u>

### 3 Preparation of a statement of cash flows



**A statement of cash flows is prepared using the statement of profit or loss and other comprehensive income for the same period and statement of financial position at the start and end of the period.**

#### 3.1 Approach

The following approach should be taken to preparing a statement of cash flows.

- Step 1** Set out the proforma statement of cash flows with the headings required by LKAS 7. You should leave plenty of space. Ideally, use three or more sheets of paper, one for the main statement, one for the notes and one for your workings.
- Step 2** Begin with the reconciliation of profit before tax to net cash from operating activities as far as possible. When preparing the statement from statements of financial position, you will usually have to calculate such items as depreciation, loss on sale of non-current assets, profit for the year and tax paid (see Step 4).
- Step 3** Calculate the cash flow figures for dividends paid, purchase or sale of non-current assets, issue of shares and repayment of loans if these are not already given to you (as they may be).
- Step 4** If you are not given the profit figure, open up a working for the trading, income and expense account. Using the opening and closing balances, the taxation charge and dividends paid, you will be able to calculate profit for the year as the balancing figure to put as the net profit in the net cash flow from operating activities section.
- Step 5** You will now be able to complete the statement by slotting in the figures given or calculated.

#### 3.2 Calculation of cash flows

##### 3.2.1 Cash generated from operations

Cash generated from operations is within the cash flows from operating activities section of the statement of cash flows. It includes cash flows from day-to-day trading such as cash received from customers and paid to suppliers.

The Standard offers a choice of method for this part of the statement of cash flows.

- (a) **The direct method**, which requires individual cash flows from customers and to suppliers and employees and so on to be established.
- (b) **The indirect method**, which takes net profit or loss and adjusts it for:
- The effects of transactions of a non-cash nature
  - Deferrals or accruals of past or future operating cash receipts or payments
  - Items of income or expense associated with investing or financing cash flows

LKAS 7 encourages use of the direct method, as this method provides information that may be useful in estimating future cash flows. It does not, however, require it, and in fact the indirect method is the more widely used method of the two.

### The direct method

A proforma for the direct method is given below.

	Rs'000	Rs'000
<i>Cash flows from operating activities</i>		
Cash receipts from customers	X	
Cash paid to suppliers and employees	<u>(X)</u>	
Cash generated from operations	X	
Interest paid	<u>(X)</u>	
Income taxes paid	<u>(X)</u>	
<i>Net cash from operating activities</i>		X

### The indirect method

A **proforma** for the indirect method is given below.

	Rs
Profit before interest and tax (statement of profit or loss)*	X
Add depreciation	X
Loss (profit) on sale of non-current assets	X
(Increase)/decrease in inventories	(X)/X
(Increase)/decrease in receivables	(X)/X
Increase/(decrease) in payables	<u>X/(X)</u>
Cash generated from operations	X
Interest (paid)/received	<u>(X)</u>
Income taxes paid	<u>(X)</u>
<i>Net cash flows from operating activities</i>	<u><u>X</u></u>

\* Take profit before tax and add back any interest expense.

### 3.2.2 Interest

Interest paid and received is calculated by reference to finance costs/interest income within the statement of profit or loss, adjusted for any accrual or other relevant amount in the statement of financial position.

### 3.2.3 Income taxes paid

Tax paid (or refunded) is calculated by reference to the income tax charge/credit in the statement of profit or loss, adjusted for both the tax liability and deferred tax balance at the start and end of the reporting period.

### 3.2.4 Non-current assets

A working should be set up to reconcile the carrying amount of property, plant and equipment at the start of the period to the end of the period. Reconciling amounts may include depreciation, disposals (at carrying amount), revaluations and finance lease additions. Cash paid to acquire property, plant and equipment can be found as a balancing figure.

A similar working is used to find cash paid to acquire intangible assets.

In both cases, the proceeds of a sale are calculated as carrying amount at the disposal date adjusted for profit or loss on disposal.

### 3.2.5 Finance lease payments

Finance lease rentals include both capital and interest payments.

- (a) The interest element of a payment is reported in the statement of profit or loss as part of the finance cost and therefore in the statement of cash flows as interest paid (an operating cash flow).
- (b) The capital element of a payment is reported as a financing cash flow. It is found by reconciling the total finance lease liability at the start of the period to that at the end of the period.

### 3.2.6 Borrowings and share capital

The proceeds of a share issue or loan issued or repaid is calculated by comparing the balance at the start of the period with that at the end of the period.

The first of the following two questions is adapted from the KE1 Study Text. The second is a new question with more complex matters to consider.

**QUESTION****Statement of cash flows 1**

Set out below are the financial statements of Kalugala Trading Co. You are the financial controller, faced with the task of implementing LKAS 7 *Statement of cash flows*.

Kalugala Trading Co

**STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X2**

	Rs'000
Revenue	2,553
Cost of sales	<u>(1,814)</u>
Gross profit	739
Distribution costs	(125)
Administrative expenses	<u>(264)</u>
	350
Interest received	25
Interest paid	<u>(75)</u>
Profit before taxation	300
Taxation	<u>(140)</u>
Profit for the year	<u><u>160</u></u>

Kalugala Trading Co

**STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER**

	20X2 Rs'000	20X1 Rs'000
<i>Assets</i>		
Non-current assets:		
Property, plant and equipment	380	305
Intangible assets	250	200
Investments	–	25
Current assets:		
Inventories	150	102
Receivables	390	315
Short term investments	50	–
Cash in hand	<u>2</u>	<u>1</u>
<i>Total assets</i>	<u><u>1,222</u></u>	<u><u>948</u></u>

	20X2 Rs'000	20X1 Rs'000
<i>Equity and liabilities</i>		
Equity:		
Stated capital	360	300
Revaluation reserve	100	91
Retained earnings	260	180
Non-current liabilities:		
Loan	170	50
Current liabilities:		
Trade payables	127	119
Bank overdraft	85	98
Taxation	<u>120</u>	<u>110</u>
<i>Total equity and liabilities</i>	<u>1,222</u>	<u>948</u>

The following information is available.

- (a) The proceeds of the sale of non-current asset investments amounted to Rs. 30,000.
- (b) Fixtures and fittings, with an original cost of Rs. 85,000 and a carrying amount of Rs. 45,000, were sold for Rs. 32,000 during the year.
- (c) The following information relates to property, plant and equipment

	31.12.20X2 Rs'000	31.12.20X1 Rs'000
Cost	720	595
Accumulated depreciation	<u>340</u>	<u>290</u>
Carrying amount	<u>380</u>	<u>305</u>

- (d) 50,000 ordinary shares were issued during the year at Rs. 1.20 per share.
- (e) Dividends totalling Rs. 80,000 were paid during the year.

### Required

**Prepare** the statement of cash flows for Kalugala Trading Co for the year to 31 December 20X2, using the format laid out in LKAS 7.

**ANSWER****Kalugala Trading Co****STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X2**

	Rs'000	Rs'000
<i>Net cash flows from operating activities</i>		
Profit before tax	300	
Depreciation charge (W1)	90	
Interest expense	50	
Loss on sale of property, plant and equipment (45 – 32)	13	
Profit on sale of non-current asset investments (30 – 25)	(5)	
(Increase)/decrease in inventories	(48)	
(Increase)/decrease in receivables	(75)	
Increase/(decrease) in payables	8	
<i>Cash generated from operating activities</i>	<u>333</u>	
Interest received	25	
Interest paid	(75)	
Dividends paid	(80)	
Tax paid (110 + 140 – 120)	<u>(130)</u>	
<i>Net cash flow from operating activities</i>		73
<i>Cash flows from investing activities</i>		
Payments to acquire property, plant and equipment (W2)	(201)	
Payments to acquire intangible non-current assets (250 – 200)	(50)	
Receipts from sales of property, plant and equipment	32	
Receipts from sale of non-current asset investments	<u>30</u>	
<i>Net cash flows from investing activities</i>		(189)
<i>Cash flows from financing activities</i>		
Issue of stated capital (360 – 300)	60	
Long-term loan (170 – 50)	<u>120</u>	
<i>Net cash flows from financing</i>		<u>180</u>
Increase in cash and cash equivalents (W4)		64
Cash and cash equivalents at 1.1 X2 (1 – 98)		<u>(97)</u>
Cash and cash equivalents at 31.12.X2 (2 + 50 – 85)		<u>(33)</u>

*Workings*1 *Depreciation charge*

	Rs'000	Rs'000
Depreciation at 31 December 20X2		340
Depreciation 31 December 20X1	290	
Depreciation on assets sold (85 – 45)	<u>40</u>	
		<u>250</u>
Charge for the year		<u>90</u>

2	<i>Purchase of property, plant and equipment</i>	
		Rs'000
	1 January 20X2	595
	Revaluation	9
	Disposals	(85)
	Cash additions (balancing figure)	<u>201</u>
	31 December 20X2	720
3	<i>Tax paid</i>	
		Rs'000
	1 January 20X2	110
	Statement of profit or loss	140
	Tax paid (balancing figure)	<u>(130)</u>
	31 December 20X2	120
4	Cash and cash equivalents	Rs'000
	Cash in hand (2 – 1)	1
	Short-term investments (50 – 0)	50
	Bank overdraft ((85) – (98))	<u>13</u>
	Change	64



## QUESTION

## Statement of cash flows 2

The financial statements of Meepitiya Models (Pvt) Ltd for the year ended 31 December 20X4 are set out below.

### Meepitiya Models (Pvt) Ltd

#### STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X4

	Rs'000
Revenue	7,740
Cost of sales	<u>(5,290)</u>
Gross profit	2,450
Release of government grant	50
Provision for warranties	(67)
Distribution costs	(91)
Administrative expenses	<u>(164)</u>
	2,178
Finance cost	<u>(320)</u>
Profit before taxation	1,858
Taxation	<u>(368)</u>
Profit for the year	1,490
Other comprehensive income: property revaluation	<u>(180)</u>
Total comprehensive income	<u>1,310</u>



**Meepitiya Models (Pvt) Ltd****STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER**

	<i>20X4</i>	<i>20X3</i>
	Rs'000	Rs'000
<i>Assets</i>		
Non-current assets:		
Property, plant and equipment	3,480	3,024
Intangible assets	3,342	3,100
Investments	1,200	900
Current assets:		
Inventories	620	615
Receivables	490	425
Short-term investments	200	-
Cash in hand	-	90
<i>Total assets</i>	<u>9,332</u>	<u>8,154</u>
<i>Equity and liabilities</i>		
Equity:		
Stated capital	500	390
Revaluation reserve	220	400
Retained earnings	3,600	2,340
Non-current liabilities:		
Loan stock	1,375	1,560
Redeemable preference shares	1,200	1,200
Finance lease obligation	140	120
Deferred tax	325	240
Provision for warranties	474	407
Government grant	250	300
Current liabilities:		
Trade payables	350	320
Finance lease obligation	390	480
Government grant	50	50
Bank overdraft	106	-
Taxation	352	347
<i>Total equity and liabilities</i>	<u>9,332</u>	<u>8,154</u>

The following information is available.

- (a) Depreciation of Rs. 280,000 is included in cost of sales. No amortisation has been charged on intangible assets as these are the costs of developing a new product that is not yet ready for use.
- (b) Equipment with a fair value of Rs. 60,000 was acquired under a finance lease during the year.

- (c) Finance costs include loan stock interest of Rs. 110,000, finance lease interest of Rs. 35,000 and a redeemable preference share dividend of Rs. 95,000.

### Required

**Prepare** the statement of cash flows for Meepitiya Models (Pvt) Ltd for the year to 31 December 20X4.

## ANSWER

### Meepitiya Models (Pvt) Ltd

#### STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X4

	Rs'000	Rs'000
<i>Net cash flows from operating activities</i>		
Profit before tax	1,858	
Finance cost	320	
Depreciation charge	280	
Non cash income – grant release	(50)	
Increase in warranty provision	67	
(Increase)/decrease in inventories	(5)	
(Increase)/decrease in receivables	(65)	
Increase/(decrease) in payables	<u>30</u>	
<i>Cash generated from operating activities</i>	2,435	
Interest paid	(320)	
Dividends paid (W1)	(230)	
Tax paid (W2)	<u>(278)</u>	
<i>Net cash flow from operating activities</i>		1,607
<i>Cash flows from investing activities</i>		
Payments to acquire property, plant and equipment (W3)	(856)	
Payments to acquire intangible non-current assets (3,342 – 3,100)	(242)	
Payments to acquire long-term investments (1,200 – 900)	(300)	
Payments to acquire short-term investments	<u>(200)</u>	
<i>Net cash flows from investing activities</i>		(1,598)
<i>Cash flows from financing activities</i>		
Issue of stated capital (500 – 390)	110	
Finance lease capital repayments (W4)	(130)	
Repayment of loan stock (1,560 – 1,375)	<u>(185)</u>	

	Rs'000	Rs'000
<i>Net cash flows from financing</i>		<u>(205)</u>
Increase in cash and cash equivalents (W4)		(196)
Cash and cash equivalents b/f		<u>90</u>
Cash and cash equivalents at c/f		<u>(106)</u>

*Workings*1 *Dividends paid*

	Rs'000	Rs'000
Retained earnings b/f		2,340
Profit for the year		1,490
Dividends paid (balance)		(230)
		<u>3,600</u>
Retained earnings c/f		<u>3,600</u>

2 *Tax paid*

	Rs'000
Balance b/f (240 + 347)	587
Statement of profit or loss	368
Tax paid (balancing figure)	<u>(278)</u>
Balance c/f (325 + 352)	677

3 *Purchase of property, plant and equipment*

	Rs'000
Balance b/f	3,024
Revaluation	(180)
Depreciation	(280)
Finance lease additions	60
Cash additions (balancing figure)	<u>856</u>
31 December 20X2	3,480

4 *Finance lease obligation*

	Rs'000
Balance b/f (120 + 480)	600
Additions	60
Cash repayment	<u>(130)</u>
Balance c/f (140 + 390)	530

## 4 Disclosure



**LKAS 7 requires disclosure of non-cash transactions, components of cash and cash equivalents and other disclosures.**

### 4.1 Non-cash transactions

Investing and financing transactions that do not require the use of cash or cash equivalents are excluded from a statement of cash flows. These include, for example, a bonus issue of shares, the conversion of convertible loan stock and share-based payments.

These transactions should be disclosed elsewhere in the financial statements in a way that provides all relevant information about these investing and financing activities. This enables users of the financial statements to assess the impact of these transactions on future cash flows.

### 4.2 Components of cash and cash equivalents

The components of cash and cash equivalents should be disclosed and a reconciliation should be presented, showing the amounts in the statement of cash flows, reconciled with the equivalent items reported in the statement of financial position.

It is also necessary to disclose the accounting policy used in deciding the items included in cash and cash equivalents, in accordance with LKAS 1 *Presentation of financial statements*, but also because of the wide range of cash management practices worldwide.



#### 4.2.1 Example: cash and cash equivalents disclosure

The following cash and cash equivalents note is for Kalugala Trading Co (see question in Section 3).

##### NOTES TO THE STATEMENT OF CASH FLOWS

	20X2	20X1	Change in year
	Rs'000	Rs'000	Rs'000
Cash in hand	2	1	1
Short-term investments	50	–	50
Bank overdraft	(85)	(98)	13
	<u>(33)</u>	<u>(97)</u>	<u>64</u>

### 4.3 Other disclosures

All entities should disclose, together with **a commentary by management**, any other information likely to be of importance, for example:

- (a) Restrictions on the use of, or access to, any part of cash equivalents
- (b) The amount of undrawn borrowing facilities that are available
- (c) Cash flows that increased operating capacity; compared with cash flows that merely maintained operating capacity

**CHAPTER ROUNDUP**

- ↳ **LKAS 1 requires that a statement of cash flows is presented in a complete set of financial statements. LKAS 7 *Statements of cash flows* provides guidance on the format and preparation.**
- ↳ **LKAS 7 requires that cash flows are classified as cash flows from operating, investing and financing activities.**
- ↳ **A statement of cash flows is prepared using the statement of profit or loss and other comprehensive income for the same period and statement of financial position at the start and end of the period.**
- ↳ **LKAS 7 requires disclosure of non-cash transactions, components of cash and cash equivalents and other disclosures.**


**PROGRESS TEST**

- 1 What is the LKAS 7 preferred method of calculating cash generated by operations?
- 2 How are dividends paid classified in a statement of cash flows – operating, investing or financing cash flows?
- 3 How are finance lease payments classified in a statement of cash flows?
- 4 How is the cash flow associated with tax calculated?
- 5 Why are non-cash transactions disclosed?
- 6 A company's statement of financial position includes an environmental provision of Rs. 24m at the start of a reporting period and Rs. 76m at the end. The charge to the statement of profit or loss in the year is Rs. 67m. How does this information affect the statement of cash flow?
  - A Rs. 67m is added back to profit in the reconciliation to cash generated from operations and Rs. 15m is shown as an investing cash outflow.
  - B Rs. 67m is deducted from profit in the reconciliation to cash generated from operations and Rs. 15m is shown as an investing cash inflow.
  - C Rs. 52m is added back to profit in the reconciliation to cash generated from operations.
  - D Rs. 52m is deducted from profit in the reconciliation to cash generated from operations.
- 7 A company pays Rs. 320,000 finance lease instalments annually. At 1.1.20X4 the outstanding obligation was Rs. 1,560,000, and at 31.12.20X4 it was Rs. 1,504. What amounts are included in the statement of cash flows?
  - A Rs. 320,000 financing cash outflow
  - B Rs. 320,000 operating cash outflow
  - C Rs. 56,000 operating cash outflow and Rs. 264,000 financing cash outflow
  - D Rs. 56,000 financing cash outflow and Rs. 264,000 operating cash outflow
- 8 Which of the following need not be disclosed in accordance with LKAS 7?
  - A A bonus issue of shares
  - B A split between cash proceeds from the sale of property, plant and equipment where the sale has achieved either a profit or a loss
  - C Restrictions on the use of cash equivalents
  - D Available undrawn borrowing facilities

## ANSWERS TO PROGRESS TEST

- 1 The direct method
- 2 They may be operating or financing cash flows, more normally financing.
- 3 The interest element is an operating cash flow and the capital element is a financing cash flow.
- 4 The tax charge/credit in the statement of profit or loss adjusted for tax payable and the deferred tax balance in the statement of financial position at the start and end of the period
- 5 They enable users of the financial statements to assess the impact of these transactions on future cash flows.
- 6 The answer is **C**. The cash flow is an operating cash flow.
- 7 The answer is **D**. Finance lease interest is an operating cash outflow. Finance lease capital repayments are financing cash outflows. The lease obligation reduces by Rs. 56,000, so this is the capital repayment. Therefore, the remainder of the instalment is an interest payment.
- 8 The answer is **B**. This is not a requirement of any standard.



# Part E - Small company reporting



# Small Company Reporting

## INTRODUCTION

Smaller entities may have different accounting needs from larger entities, but full SLFRS are generally designed for larger ones.

The SLFRS for small and medium-sized entities (SMEs) has been issued to reduce accounting complexity for smaller, non-publicly accountable businesses.

This chapter is largely revision of KE1 material.

Knowledge Component			
2	Sri Lanka Accounting Standards (SLFRS/LKAS/IFRIC/SIC)		
2.2	Level B	2.2.1	Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
		2.2.2	Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
		2.2.3	Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
		2.2.4	Demonstrate appropriate application and selection of accounting/reporting options given under standards.
		2.2.5	Outline the disclosures to be made in the financial statements.

**CHAPTER CONTENTS****LEARNING  
OUTCOME**

1 Introduction	2.2
2 Eligibility to use the SLFRS for SMEs	2.2
3 Content of the SLFRS for SMEs	2.2

**SLFRS for SMEs Learning objectives**

- Explain the entities that can use the SME standard in preparing and presenting financial statements.
- Outline the main differences between the SME standard and full SLFRS standards.

**1 Introduction**

**The 'big GAAP/little GAAP divide' refers to the different accounting needs of larger, publicly accountable and smaller, private companies. CASL has addressed this by issuing the SLFRS for SMEs.**

In most countries, including Sri Lanka, the majority of companies or other types of entity are very small. They are generally owned and managed by one person or a family. The owners have invested their own money in the business and there are no outside shareholders to protect.

Large entities, by contrast, particularly companies listed on a stock exchange, may have shareholders who have invested their money, possibly through a pension fund, with no knowledge whatever of the company. These shareholders need protection and the regulations for such companies need to be more stringent.

It could therefore be argued that company accounts should be of two types.

- 'Simple' ones for small companies with fewer regulations and disclosure requirements
- 'Complicated' ones for larger companies with extensive and detailed requirements

This is sometimes called the big GAAP/little GAAP divide.

## 1.1 Possible solutions

There are two approaches to overcoming the big GAAP/little GAAP divide:

- (1) Differential reporting, ie producing new reduced standards specifically for smaller companies.
- (2) Providing exemptions for smaller companies from some of the requirements of existing standards.

### 1.1.1 Differential reporting

A one-size-fits-all framework does not generate relevant and useful information, even if this information is reliable:

- (a) The costs may not be justified for the more limited needs of users of SME accounts.
- (b) The purpose of the financial statements and the use to which they are put will not be the same as for listed companies.

Differential reporting overcomes this by tailoring the reporting requirements to the entity. The main characteristic that distinguishes SMEs from other entities is the degree of public accountability. For example, a listed company or a public utility, or a company such as a bank, which holds assets in a fiduciary capacity might be regarded as publicly accountable. Despite the name 'small and medium-sized entity (SME)', size is not the only or even the main criterion. (This was the position the IASB and CASL adopted – see Section 2.)

Differential reporting may have drawbacks in terms of reducing comparability between small and larger company accounts.

Furthermore, problems may arise where entities no longer meet the criteria to be classified as small.

### 1.1.2 Exemptions from existing standards

Some accounting standards do not have any bearing on small company accounts; for example, a company with equity not quoted on a stock exchange has no need to comply with LKAS 33 *Earnings per share*. Also, an entity with a small local market, may find SLFRS 8 *Operating segments* to be superfluous.

Other standards always have an impact. In particular, almost all small companies will be affected by the accounting standards on:

- Property, plant and equipment
- Inventories
- Presentation of financial statements

- Events occurring after the reporting period
- Taxes on income
- Revenue
- Provisions and contingencies

Does this mean that companies below a certain size should be exempt from other SLFRS? An alternative approach would be to reduce the exposure of small companies to SLFRS on a standard-by-standard basis. For those 'core' standards listed above, small companies would be required to follow all or most of their provisions. For more complicated standards, small companies would face nothing but very brief general obligations.

It is difficult to see how accounting bodies could impose any kind of specific size limits to define small companies if such an approach were adopted. Instead, it might specify that size limits within national legislation could be adopted for the purpose.

## 1.2 The SLFRS for SMEs

The IASB and CASL have adopted the differential reporting approach to the big GAAP/little GAAP divide. The IFRS for SMEs was issued by the IASB in 2009, and CASL adopted this as the SLFRS for SMEs, without making any modifications, in 2011.

The SLFRS for SMEs provides a simplified framework that can be adopted by eligible entities in the place of full SLFRSs. Eligible entities retain the choice to use full SLFRSs if they wish.

The SLFRS for SMEs is a completely independent standard that incorporates accounting principles based on full SLFRSs but that have been simplified to suit SMEs. It will be reviewed and revised every three years. Periodic rather than continual revision will again reduce the reporting burden for SMEs.

## 2 Eligibility to use the SLFRS for SMEs



**SMEs are not defined by reference to size but by the fact that they do not have public accountability. Specified Business Entities are not eligible to use the SLFRS for SMEs.**

The SLFRS for SMEs may be used by entities that meet the definition of an SME as provided in the standard and are not a Specified Business Entity (SBE).

## 2.1 Small and medium-sized entities



The SLFRS for SMEs defines a **small and medium-sized entity** as an entity that:

- (a) Does not have public accountability
- (b) Published general purpose financial statements for external users

An entity has **public accountability** if:

- (a) Its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market, or
- (b) It holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks. This is not the case for travel or real estate agents, schools, sellers that receive payment in advance of delivery of goods and so on. These entities hold the assets of outsiders for reasons incidental to their primary business.

## 2.2 Specified Business Entities

Specified Business Entities (SBEs) may not use the SLFRS for SMEs. The following companies are SBEs.

- Companies licensed under the Banking Act No 30 of 1988
- Companies authorised under the Control of Insurance Act No 25 of 1962 to carry on insurance business
- Companies carrying on leasing business
- Factoring companies
- Companies registered under the Finance Companies Act No 78 of 1988
- Companies licensed to operate unit trusts under the Securities and Exchange Commission Act No 36 of 1987
- Fund management companies
- Companies licensed to carry on business as stock brokers or stock dealers under the Securities and Exchange Commission Act No 36 of 1987
- Companies licensed to operate a Stock Exchange under the Securities and Exchange Commission Act No 36 of 1987

- Companies listed in a Stock Exchange licensed under the Securities and Exchange Commission Act No 36 of 1987
- Public corporations engaged in the sale of goods or the provision of services

### 2.3 Group companies

The SLFRS for SMEs states that a subsidiary whose parent company uses full SLFRSs may use the SLFRS for SMEs in its own financial statements provided that the subsidiary itself does not have public accountability.

## 3 Content of the SLFRS for SMEs



**The SLFRS for SMEs simplifies the recognition and measurement requirements of full SLFRSs, omits some topics, removes areas of choice and reduces disclosure compared to full SLFRSs.**

The *SLFRS for small and medium-sized entities* (SLFRS for SMEs) is only 230 pages, and has simplifications that reflect the needs of users of SMEs' financial statements and cost-benefit considerations. It is designed to facilitate financial reporting by small and medium-sized entities in a number of ways:

- Some topics are omitted because they are not relevant to typical SMEs
- Some accounting treatments in full SLFRSs are not available because a simpler method is applied instead
- Many of the recognition and measurement requirements of SLFRS are simplified
- There are substantially fewer disclosures
- The language and explanations used are simplified

Where the SLFRS for SMEs is adopted, it is a standalone standard, with one exception: there is a fallback option that allows entities to choose to apply LKAS 39 in its entirety rather than the financial instrument requirements of the SLFRS for SMEs.



### 3.1 Accounting policies

For situations where the SLFRS for SMEs does not provide specific guidance, it provides a hierarchy for determining a suitable accounting policy. An SME must consider, in descending order:

- The guidance in the SLFRS for SMEs on similar and related issues
- The definitions, recognition criteria and measurement concepts in Section 2 *Concepts and pervasive principles* of the standard

The entity also has the option of considering the requirements and guidance in full SLFRSs dealing with similar topics. However, it is under no obligation to do this, or to consider the pronouncements of other standard setters.

### 3.2 Overlap with full SLFRSs

In the following areas, the recognition and measurement guidance in the SLFRS for SMEs is equivalent to that in the full SLFRSs.

- Provisions and contingencies
- Hyperinflation accounting
- Events after the end of the reporting period

### 3.3 Omitted topics

The SLFRS for SMEs does not address the following topics that are covered in full SLFRSs because they are generally not relevant to SMEs:

- Earnings per share
- Interim financial reporting
- Segment reporting
- Classification for non-current assets (or disposal groups) as held for sale

### 3.4 Options in full SLFRS not in the SLFRS for SMEs

Certain topics are not omitted from the SLFRS for SMEs, however accounting treatment prescribed or allowed by the relevant full SLFRS is omitted:

- The revaluation model for intangible assets and property, plant and equipment
- If the fair value of investment properties can be measured reliably without undue cost or effort, then investment property must be measured at fair value; otherwise historical cost is used
- Options for government grants

### 3.5 Principal recognition and measurement simplifications

(a) **Financial instruments**

Financial instruments meeting specified criteria are measured at cost or amortised cost. All others are measured at fair value through profit or loss.

The procedure for derecognition has been simplified, as have hedge accounting requirements.

(b) **Goodwill and other indefinite-life intangibles**

An impairment test is only performed if there are indications of impairment (rather than annually). These assets are always amortised over their estimated useful life (or ten years if it cannot be estimated).

(c) **Investments in associates and jointly controlled entities**

The cost model, equity model and fair value model are permitted as an accounting policy choice that should be applied to the whole class of associates or jointly-controlled entities. An entity using the cost model must measure an investment for which there is a published price using the fair value model.

(d) **Research and development costs and borrowing costs** must be expensed.

(e) **Property, plant and equipment and intangibles**

There is no need to review residual value, useful life and depreciation method unless there is an indication that they have changed since the most recent reporting date.

(f) **Available-for-sale assets**

There is no separate available-for-sale classification; holding an asset or group of assets for sale is an indicator of impairment.

(g) **Biological assets**

SMEs are to use the cost-depreciation-impairment model unless the fair value is readily determinable, in which case the fair value through profit or loss model is required.

(h) **Equity-settled share-based payment**

If observable market prices are not available to measure the fair value of the equity-settled share-based payment, the directors' best estimate is used.

(i) **Defined benefit pension plan**

A simplified calculation of the plan obligation is allowed if measurement using the projected unit credit method involves undue cost or effort.

**(j) Exchange differences**

An exchange difference that is recognised initially in other comprehensive income is not reclassified in profit or loss on disposal of the investment in a foreign subsidiary. This treatment is less burdensome than that required under full SLFRSs because it eliminates the need for tracking exchange differences after initial recognition.

**3.6 Presentation of financial statements**

In order to reduce costs for preparers, while still meeting the needs of users, the SLFRS for SMEs has simplified financial statement presentation requirements as follows.

- (a) An entity is not required to present a statement of financial position at the beginning of the earliest comparative period when the entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements as required under LKAS 1.
- (b) An entity is permitted to present a single statement of income and retained earnings in place of separate statements of comprehensive income and changes in equity if the only changes to its equity during the periods for which financial statements are presented arise from profit or loss, payment of dividends, corrections of prior period errors, and changes in accounting policy.
- (c) All deferred tax assets and liabilities are classified as non-current assets or liabilities.

**3.7 Reduced disclosure requirements**

The disclosure requirements of the SLFRS for SMEs are substantially reduced compared to those in full SLFRS. There are approximately 300 points rather than the 3,000 in full SLFRSs. Certain disclosures have been omitted for two main reasons:

- (a) They relate to topics or accounting policy options in full SLFRS that are omitted or simplified in the SLFRS for SMEs, or
- (b) They are not considered appropriate based on users' needs and cost-benefit considerations. In particular, some disclosures in full SLFRSs are more relevant to investment decisions in public capital markets than the transactions and other events and conditions encountered by a typical SME.

**CHAPTER ROUNDUP**

- ↪ **The 'big GAAP/little GAAP divide' refers to the different accounting needs of larger, publicly accountable and smaller, private companies. CASL has addressed this by issuing the SLFRS for SMEs.**
- ↪ **SMEs are not defined by reference to size but by the fact they do not have public accountability. Specified Business Entities are not eligible to use the SLFRS for SMEs.**
- ↪ **The SLFRS for SMEs simplifies the recognition and measurement requirements of full SLFRSs, omits some topics, removes areas of choice and reduces disclosure compared to full SLFRSs.**


**PROGRESS TEST**

- 1 What are two possible solutions to the 'big GAAP/little GAAP divide'?
- 2 What is the difference between the treatment of investment properties in the *SLFRS for SMEs* and in LKAS 40?
- 3 The financial instruments categories 'held-to-maturity' and 'available-for-sale' are not included in the *SLFRS for SMEs*. True or false?
- 4 Identify two topics that are not covered in full SLFRSs.
- 5 Which of the following companies may use the SLFRS for SMEs?
  - A A private company that leases cars
  - B A company that is listed on the Colombo Stock Exchange
  - C A private company that buys the accounts receivable ledgers of other companies
  - D A private company that is engaged in the provision of legal services
- 6 Which of the following accounting treatments is allowed by the SLFRS for SMEs?
  - A The revaluation of property
  - B The recognition of development costs as an asset
  - C The measurement of financial instruments at fair value through profit or loss
  - D The reclassification of non-current assets as held for sale
- 7 Which of the following statements is/are true?
  - 1 Eligible entities must use the SLFRS for SMEs.
  - 2 The accounting treatment applied to events after the reporting period is identical to that within the relevant SLFRS.
  - A Neither
  - B 1 only
  - C 2 only
  - D Both

## ANSWERS TO PROGRESS TEST

- 1 Differential reporting or exemptions from full SLFRSs
- 2 LKAS 40 provides a choice of the cost or fair value model; the SLFRS for SMEs does not.
- 3 True, and when SLFRS 9 is in force, they will no longer be available in full SLFRSs.
- 4 Two of:
  - Earnings per share
  - Interim financial reporting
  - Segment reporting
  - Classification for non-current assets (or disposal groups) as held for sale
- 5 The answer is **D**. The other companies are either publicly accountable or Specified Business Entities.
- 6 The answer is **C**. Property must be measured using the cost model. Development costs must be expensed. Non-current assets held for sale is an omitted topic.
- 7 The answer is **C**. Eligible entities may use full SLFRSs if they wish.

# Part F - Financial statement analysis





# Financial Statement Analysis

## INTRODUCTION

This chapter looks at **interpretation of accounts**. We deal here with the calculation of ratios, how they can be analysed and interpreted, and how the results should be presented to management.

### Knowledge Component

#### 4 Financial Statement Analysis and Non-financial Reporting

##### 4.1 Financial statement analysis

- |       |  |
|-------|--|
| 4.1.1 | Demonstrate a thorough understanding of the different techniques available to analyse financial statements, including ratio analysis and common size financial statements. |
| 4.1.2 | Interpret relevant financial ratios, including profitability ratios, liquidity ratios, efficiency ratios, and gearing and solvency ratios.                                 |
| 4.1.3 | Advise on the interpretation of an entity's financial statements for different stakeholders.   |
| 4.1.4 | Demonstrate a thorough knowledge of the limitations of financial statement analysis techniques.  |

**CHAPTER CONTENTS**

- 1 Introduction and analysis techniques
- 2 Ratio analysis
- 3 Different stakeholder needs
- 4 Limitations of financial analysis

**LEARNING  
OUTCOME**

- 4.1.1  
4.1.1, 4.1.2  
4.1.3  
4.1.4

## 1 Introduction and analysis techniques



**Financial analysis involves appraising and communicating the position, performance and prospects of a business based on given and prepared statements and ratios.**

The ability to review, analyse and interpret a set of financial statements is a key skill for a financial accountant. Analysis may involve any or all of the following:

- Vertical or horizontal trend analysis
- Common size analysis
- Ratio analysis

### 1.1 Vertical or horizontal trend analysis

Trend analysis involves comparing financial statements. Vertical trend analysis is comparing the financial statements of one company from one year to the next. Horizontal analysis is comparing the financial statements of one company with those of an equivalent company in the same period.

This type of analysis involving comparisons has drawbacks:

- (a) The financial results of one year may be skewed by a significant event, making comparison with another year less meaningful. For this reason, it is more useful to perform vertical analysis over an extended period rather than just two years.
- (b) An 'equivalent company', ie a company of a similar size in the same industry may be difficult to find, and if one is found, its results for a particular year may, again, be skewed by a particular event.

## 1.2 Common size analysis

Common size analysis again involves comparison – either of the same company in different periods or different companies in the same period.

In this case, however, comparison is not of the 'raw' numbers presented in the financial statements.

Instead, a common base figure is adopted and amounts are expressed as a percentage of this base number. These percentages are then compared. A common base figure when analysing the statement of profit or loss is revenue.



### 1.2.1 Example: common size analysis

The following example shows the results of one company for two years.

	2014	% of	2013	% of
	Rs'000	revenue	Rs	revenue
Revenue	100,000		90,000	
Cost of sales	<u>(35,000)</u>	35%	<u>(30,000)</u>	33%
Gross profit	65,000		60,000	
Distribution costs	<u>(20,000)</u>	20%	<u>(16,000)</u>	18%
Administrative expenses	<u>(15,000)</u>	15%	<u>(21,000)</u>	23%
Operating profit	30,000		23,000	
Finance costs	<u>(5,000)</u>	5%	<u>(3,000)</u>	3%
Profit before tax	25,000		20,000	
Tax	<u>(5,000)</u>	5.3%	<u>(4,000)</u>	4%
Retained profit	20,000		16,600	

As the revenue in the company has increased, it follows that costs might increase. Common size analysis helps to identify whether costs have increased proportionately. Questions that might be asked as a result of performing this analysis are as follows.

- Why has cost of sales increased as a proportion of revenue? Have selling prices reduced while cost per unit remains the same or have costs increased?
- Why have distribution costs increased as a proportion of revenue? Have costs such as petrol increased or are proportionately more items being distributed (this would be the case if prices have decreased)?
- There is a significant drop in the proportion of revenue spent on admin expenses. Is there a one-off item of income in 2014 or a one-off expense in 2013 that has caused the change?

- (d) Finance costs as a proportion of revenue have increased; the company appears to have borrowed money in the year. This has been employed in the business and resulted in increased revenue.

### 1.3 Ratio analysis

Ratio analysis involves manipulating amounts in the financial statements to produce a ratio. This is then compared with the same ratio for any of:

- The same company in a different year
- A different company in the same year
- Industry averages

Ratios can be grouped into five categories:

- Profitability
- Long-term solvency
- Short-term liquidity
- Efficiency (turnover ratios)
- Shareholders' investment ratios

Each of these categories is considered in turn in the next section of this chapter.

## 2 Ratio analysis



**Ratios can be grouped into five categories: profitability, solvency, liquidity, efficiency and investor ratios.**

For each of the categories of ratio, we will identify a number of standard measures or ratios that are normally calculated and generally accepted as meaningful indicators.

It must be stressed, however, that each individual business must be considered separately, and a ratio that is meaningful for a manufacturing company may be completely meaningless for a financial institution. Try not to be too mechanical when working out ratios and constantly think about what you are trying to achieve.

It is also important to remember that ratio analysis on its own is not sufficient for interpreting company accounts, and that there are other items of information that should be looked at, for example:

- (a) The content of any accompanying commentary on the accounts and other statements
- (b) The age and nature of the company's assets

- (c) Current and future developments in the company's markets, at home and overseas, recent acquisitions or disposals of a subsidiary by the company
- (d) Unusual items separately disclosed in the financial statements
- (e) Any other noticeable features of the report and accounts, such as events after the end of the reporting period, contingent liabilities, a qualified auditors' report, the company's taxation position, and so on

## 2.1 Illustrative financial statements

To illustrate the calculation of ratios, the following statement of financial position and statement of profit or loss figures will be used. We are using a separate statement of profit or loss for this example, as no items of other comprehensive income are involved.

### PACIFIC CO STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X8

	<i>Notes</i>	<i>20X8</i> Rs'000	<i>20X7</i> Rs'000
Revenue	1	<u>3,095,576</u>	<u>1,909,051</u>
Operating profit	1	359,501	244,229
Interest	2	<u>17,371</u>	<u>19,127</u>
Profit before taxation		342,130	225,102
Income tax expense		<u>74,200</u>	<u>31,272</u>
Profit for the year		<u>267,930</u>	<u>193,830</u>
Earnings per share		12.8	9.3

## PACIFIC CO STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X8

	<i>Notes</i>	<i>20X8</i> Rs'000	<i>20X7</i> Rs'000
<i>Assets</i>			
Non-current assets			
Property, plant and equipment		<u>802,180</u>	<u>656,071</u>
Current assets			
Inventory		64,422	86,550
Receivables	3	1,002,701	853,441
Cash at bank and in hand		<u>1,327</u>	<u>68,363</u>
		<u>1,068,450</u>	<u>1,008,354</u>
<i>Total assets</i>		<u>1,870,630</u>	<u>1,664,425</u>
<i>Equity and liabilities</i>			
Equity			
Stated capital		258,178	258,178
Retained earnings		<u>651,721</u>	<u>410,591</u>
		909,899	668,769
Non-current liabilities			
10% loan stock 20Y0		100,000	100,000
Current liabilities	4	<u>860,731</u>	<u>895,656</u>
<i>Total equity and liabilities</i>		<u>1,870,630</u>	<u>1,664,425</u>

**Notes to the accounts**

	<i>20X8</i> Rs'000	<i>20X7</i> Rs'000
1 <i>Sales revenue and profit</i>		
Sales revenue	3,095,576	1,909,051
Cost of sales	<u>2,402,609</u>	<u>1,441,950</u>
Gross profit	692,967	467,101
Administration expenses	<u>333,466</u>	<u>222,872</u>
Operating profit	<u>359,501</u>	<u>244,229</u>
Depreciation charged	151,107	120,147
2 <i>Interest</i>		
Payable on bank overdrafts and other loans	8,115	11,909
Payable on loan stock	<u>10,000</u>	<u>10,000</u>
	18,115	21,909
Receivable on short-term deposits	<u>744</u>	<u>2,782</u>
Net payable	<u>17,371</u>	<u>19,127</u>
3 <i>Receivables</i>		
Amounts falling due within one year		
Trade receivables	905,679	807,712
Prepayments and accrued income	<u>97,022</u>	<u>45,729</u>
	<u>1,002,701</u>	<u>853,441</u>

4	<i>Current liabilities</i>		
	Trade payables	627,018	545,340
	Accruals and deferred income	81,279	280,464
	Corporate taxes	108,000	37,200
	Other taxes	<u>44,434</u>	<u>32,652</u>
		<u>860,731</u>	<u>895,656</u>
5	Dividends paid	20,000	–

## 2.2 Profitability ratios

In our example, the company made a profit in both 20X8 and 20X7, and there was an increase in profit between one year and the next:

- (a) Of 52% before taxation
- (b) Of 39% after taxation

Profit before taxation is generally thought to be a better figure to use than profit after taxation, because there might be unusual variations in the tax charge from year to year which would not affect the underlying profitability of the company's operations.

Another profit figure that should be calculated is profit before interest and tax (PBIT). This is the amount of profit that the company earned before having to pay interest to the providers of loan capital, such as loan notes and medium-term bank loans, which will be shown in the statement of financial position as non-current liabilities. It is therefore calculated as profit before tax plus interest charges on long-term finance.

Published accounts do not always give sufficient detail on interest payable to determine how much is interest on long-term finance. We will assume in our example that the whole of the interest payable (Rs. 18,115,000 – note 2) relates to long-term finance.

PBIT in our example is therefore:

	20X8	20X7
	Rs'000	Rs'000
Profit on ordinary activities before tax	342,130	225,102
Interest payable	<u>18,115</u>	<u>21,909</u>
PBIT	<u>360,245</u>	<u>247,011</u>

This shows a 46% growth between 20X7 and 20X8.

### 2.2.1 Return on capital employed (ROCE)

It is impossible to assess profits or profit growth properly without relating them to the amount of funds (capital) that were employed in making the profits. The most important profitability ratio is therefore return on capital employed (ROCE), which states the profit as a percentage of the amount of capital employed.



#### FORMULA TO LEARN

$$\text{ROCE} = \frac{\text{Profit before interest and taxation}}{\text{Total assets less current liabilities}} \times 100\%$$

$$\text{Capital employed} = \text{Shareholders' equity plus non-current liabilities} \\ \text{(or total assets less current liabilities)}$$

The underlying principle is that we must compare like with like, and so if capital means share capital and reserves plus non-current liabilities and debt capital, profit must mean the profit earned by all this capital together. This is PBIT, since interest is the return for loan capital.

In our example, capital employed is:

$$20X8 \text{ Rs. } 1,870,630 - \text{Rs. } 860,731 = \text{Rs. } 1,009,899$$

$$20X7 \text{ Rs. } 1,664,425 - \text{Rs. } 895,656 = \text{Rs. } 768,769$$

These total figures are the total assets less current liabilities figures for 20X8 and 20X7 in the statement of financial position.

	<i>20X8</i>	<i>20X7</i>
ROCE	$\frac{\text{Rs. } 360,245}{\text{Rs. } 1,009,899} = 35.7\%$	$\frac{\text{Rs. } 247,011}{\text{Rs. } 768,769} = 32.1\%$

What does a company's ROCE tell us? In effect, a ROCE of 35.7% means that for every Rs. 100 of capital invested in the company, management create Rs. 35.7 of profits. Therefore, ROCE is a measure to assess how well capital is used to generate profit.

What should we be looking for? There are three comparisons that can be made.

- (a) The change in ROCE from one year to the next can be examined. In this example, there has been an increase in ROCE by about four percentage points from its 20X7 level.
- (b) The ROCE being earned by other companies, if this information is available, can be compared with the ROCE of this company. Here the information is not available.



- (c) A comparison of the ROCE with current market borrowing rates may be made.
- (i) What would be the cost of extra borrowing to the company if it needed more loans, and is it earning a ROCE that suggests it could make profits to make such borrowing worthwhile?
  - (ii) Is the company making a ROCE that suggests that it is getting value for money from its current borrowing?
  - (iii) Companies are in a risk business and commercial borrowing rates are a good independent yardstick against which company performance can be judged.

In this example, if we suppose that current market interest rates, say, for medium-term borrowing from banks, are around 10%, then the company's actual ROCE of 36% in 20X8 would not seem low. On the contrary, it might seem high.

However, it is easier to spot a low ROCE than a high one, because there is always a chance that the company's non-current assets, especially property, are undervalued in its statement of financial position, and so the capital employed figure might be unrealistically low. If the company had earned a ROCE, not of 36%, but of, say, only 6%, then its return would have been below current borrowing rates and so disappointingly low.

### 2.2.2 Return on equity

Return on equity (ROE) gives a more restricted view of capital than ROCE, but it is based on the same principles.



#### FORMULA TO LEARN

$$\text{ROE} = \frac{\text{Profit after tax and preference dividend}}{\text{Equity shareholders fund}} \times 100\%$$

In our example, ROE is calculated as follows.

	$\frac{\text{Rs. 267,930}}{\text{Rs. 909,899}} = 29.4\%$	$\frac{\text{Rs. 193,830}}{\text{Rs. 668,769}} = 29\%$
ROE		

ROE is **not a widely-used ratio**, however, because there are more useful ratios that give an indication of the return to shareholders, such as earnings per share, dividend per share, dividend yield and earnings yield, which are described later.

### 2.2.3 Analysing profitability and return in more detail: the secondary ratios

We often sub-analyse ROCE, to find out more about why the ROCE is high or low, or better or worse than last year. There are two factors that contribute towards a return on capital employed, both related to sales revenue.

- (a) **Profit margin.** A company might make a high or low profit margin on its sales. For example, a company that makes a profit of Rs. 25 per Rs. 100 of sales is making a bigger return on its revenue than another company making a profit of only Rs. 10 per Rs. 100 of sales.
- (b) **Asset turnover.** Asset turnover is a measure of how well the assets of a business are being used to generate sales. For example, if two companies each have capital employed of Rs. 100m and Company A makes sales of Rs. 400m per annum whereas Company B makes sales of only Rs. 200m per annum, Company A is making a higher revenue from the same amount of assets (twice as much asset turnover as Company B) and this will help A to make a higher return on capital employed than B. Asset turnover is expressed as 'x times' so that assets generate x times their value in annual sales. Here, Company A's asset turnover is 4 times and B's is 2 times.

Profit margin and asset turnover together explain the ROCE and if the ROCE is the primary profitability ratio, these other two are the secondary ratios. The relationship between the three ratios can be shown mathematically.



#### FORMULA TO LEARN

Profit margin  $\times$  Asset turnover = ROCE

$$\therefore \frac{\text{PBIT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Capital employed}} = \frac{\text{PBIT}}{\text{Capital employed}}$$

In our example:

	<i>Profit margin</i>	<i>Asset turnover</i>	<i>ROCE</i>
(a) 20X8	$\frac{\text{Rs.360,245}}{\text{Rs.3,095,576}}$ 11.64%	$\times \frac{\text{Rs.3,095,576}}{\text{Rs.1,009,899}}$ $\times 3.07 \text{ times}$	$= \frac{\text{Rs.360,245}}{\text{Rs.1,009,899}}$ $= 35.7\%$
(b) 20X7	$\frac{\text{Rs.247,011}}{\text{Rs.1,909,051}}$ 12.94%	$\times \frac{\text{Rs.1,909,051}}{\text{Rs.768,769}}$ $\times 2.48 \text{ times}$	$= \frac{\text{Rs.247,011}}{\text{Rs.768,769}}$ $= 32.1\%$

In this example, the company's improvement in ROCE between 20X7 and 20X8 is attributable to a higher asset turnover. Indeed, the profit margin

has fallen a little, but the higher asset turnover has more than compensated for this.

It is also worth commenting on the change in sales revenue from one year to the next. You may already have noticed that Pacific achieved sales growth of over 60% from Rs. 1,900m to Rs. 3,100m between 20X7 and 20X8. This is very strong growth, and this is certainly one of the most significant items in the statement of profit or loss and statement of financial position.

#### 2.2.4 A warning about comments on profit margin and asset turnover

It might be tempting to think that a high profit margin is good, and a low asset turnover means sluggish trading. In broad terms, this is so. But there is a trade-off between profit margin and asset turnover, and you cannot look at one without allowing for the other.

- (a) A **high profit margin** means a high profit per Rs. 100 of sales, but if this also means that sales prices are high, there is a strong possibility that sales revenue will be depressed, and so asset turnover lower.
- (b) A **high asset turnover** means that the company is generating a lot of sales, but to do this it might have to keep its prices down and so accept a low profit margin per Rs. 100 of sales.

Consider the following.

<i>Company A</i>		<i>Company B</i>	
Sales revenue	Rs. 10m	Sales revenue	Rs. 40m
Capital employed	Rs. 10m	Capital employed	Rs. 10m
PBIT	Rs. 2m	PBIT	Rs. 2m

These figures would give the following ratios.

$$\text{ROCE} = \frac{\text{Rs. 2m}}{\text{Rs. 10m}} = 20\% \quad \text{ROCE} = \frac{\text{Rs. 2m}}{\text{Rs. 10m}} = 20\%$$

$$\text{Profit margin} = \frac{\text{Rs. 2m}}{\text{Rs. 10m}} = 20\% \quad \text{Profit margin} = \frac{\text{Rs. 2m}}{\text{Rs. 40m}} = 5\%$$

$$\text{Asset turnover} = \frac{\text{Rs. 10m}}{\text{Rs. 10m}} = 1 \quad \text{Asset turnover} = \frac{\text{Rs. 40m}}{\text{Rs. 10m}} = 4$$

The companies have the same ROCE, but it is arrived at in a very different fashion. Company A operates with a low asset turnover and a comparatively high profit margin, whereas company B carries out much more business, but

on a lower profit margin. Company A could be operating at the luxury end of the market, while company B is operating at the popular end of the market.

### 2.2.5 Gross profit margin, net profit margin and profit analysis

Depending on the format of the statement of profit or loss, you may be able to calculate the gross profit margin as well as the net profit margin. Looking at the two together can be quite informative.

For example, suppose that a company has the following summarised statement of profit or loss for two consecutive years.

	<i>Year 1</i>	<i>Year 2</i>
	Rs'000	Rs'000
Revenue	70,000	100,000
Cost of sales	<u>42,000</u>	<u>55,000</u>
Gross profit	28,000	45,000
Expenses	<u>21,000</u>	<u>35,000</u>
Profit for the year	<u><u>7,000</u></u>	<u><u>10,000</u></u>

Although the net profit margin is the same for both years at 10%, the gross profit margin is not.

In year 1, it is:  $\frac{\text{Rs. } 28,000}{\text{Rs. } 70,000} = 40\%$

And in year 2, it is:  $\frac{\text{Rs. } 45,000}{\text{Rs. } 100,000} = 45\%$

The improved gross profit margin has not led to an improvement in the net profit margin. This is because expenses as a percentage of sales have risen from 30% in year 1 to 35% in year 2.

## 2.3 Solvency ratios

Debt ratios are concerned with **how much the company owes in relation to its size**, whether it is getting into heavier debt or improving its situation, and whether its debt burden seems heavy or light.

- (a) When a company is heavily in debt, banks and other potential lenders may be unwilling to advance further funds.
- (b) When a company is earning only a modest profit before interest and tax, and has a heavy debt burden, there will be very little profit left over for shareholders after the interest charges have been paid. And so if interest rates were to go up (on bank overdrafts and so on) or the company were to

borrow even more, it might soon be incurring interest charges in excess of PBIT. This might eventually lead to the liquidation of the company.

These are two big reasons why companies should keep their debt burden under control. There are four ratios that are particularly worth looking at, the debt ratio, gearing ratio, interest cover and cash flow ratio.

### 2.3.1 Debt ratio

The debt ratio is the ratio of a company's total debts to its total assets.

- (a) Assets consist of non-current assets at their carrying amount, plus current assets.
- (b) Debts consist of all payables, whether they are due within one year or after more than one year.

You can ignore other non-current liabilities, such as deferred taxation.

There is no absolute guide to the maximum safe debt ratio, but as a very general guide, you might regard 50% as a safe limit to debt. In practice, many companies operate successfully with a higher debt ratio than this, but 50% is nonetheless a helpful benchmark. In addition, if the debt ratio is over 50% and getting worse, the company's debt position will be worth looking at more carefully.

In the case of Pacific, the debt ratio is as follows.

	20X8	20X7
Total debts	Rs. (860,731 + 100,000)	Rs. (895,731 + 100,000)
Total assets	Rs. 1,870,630	Rs. 1,664,425
	= 51%	= 60%

In this case, the debt ratio is quite high, mainly because of the large amount of current liabilities. However, the debt ratio has fallen from 60% to 51% between 20X7 and 20X8, and so the company appears to be improving its debt position.

### 2.3.2 Gearing ratio

Gearing or leverage is concerned with a company's long-term capital structure. We can think of a company as consisting of non-current assets and net current assets (ie working capital, which is current assets minus current liabilities). These assets must be financed by long-term capital of the company, which is one of two things.

- (a) Issued share capital which can be divided into:
  - (i) Ordinary shares plus other equity (eg reserves)
  - (ii) Non-redeemable preference shares (unusual)

## (b) Long-term debt including redeemable preference shares

Preference share capital is normally classified as a non-current liability in accordance with LKAS 32, and preference dividends (paid or accrued) are included in finance costs in profit or loss.

The capital gearing ratio is a measure of the proportion of a company's capital that is debt. It is measured as follows.



## FORMULA TO LEARN

$$\text{Gearing} = \frac{\text{Interest bearing debt}}{\text{Shareholders' equity} + \text{interest bearing debt}} \times 100\%$$

As with the debt ratio, there is no absolute limit to what a gearing ratio ought to be. A company with a gearing ratio of more than 50% is said to be high-gearred (whereas low gearing means a gearing ratio of less than 50%). Many companies are high geared, but if a high geared company is becoming increasingly high geared, it is likely to have difficulty in the future when it wants to borrow even more, unless it can also boost its shareholders' capital, either with retained profits or by a new share issue.

Leverage is an alternative term for gearing; the words have the same meaning. Note that leverage (or gearing) can be looked at conversely, by calculating the proportion of total assets financed by equity, and which may be called the equity to assets ratio. It is calculated as follows.



## FORMULA TO LEARN

$$\text{Equity to assets ratio} = \frac{\text{Shareholders' equity}}{\text{Shareholders' equity} + \text{interest bearing debt}} \times 100\%$$

$$\text{Or} \quad \frac{\text{Shareholders' equity}}{\text{Total assets less current liabilities}} \times 100\%$$

In the example of Pacific, we find that the company, although having a high debt ratio because of its current liabilities, has a low gearing ratio. It has no preference share capital and its only long-term debt is the 10% loan stock. The equity to assets ratio is therefore high.

		20X8	20X7
Gearing ratio	=	$\frac{\text{Rs. 100,000}}{\text{Rs. 1,009,899}}$	$\frac{\text{Rs. 100,000}}{\text{Rs. 768,769}}$
		= 10%	= 13%

Equity to assets ratio =	$\frac{\text{Rs. } 909,899}{\text{Rs. } 1,009,899}$	$\frac{\text{Rs. } 668,769}{\text{Rs. } 768,769}$
	= 90%	= 87%

As you can see, the equity to assets ratio is the mirror image of gearing.

### 2.3.3 The implications of high or low gearing

We mentioned earlier that gearing or leverage is, amongst other things, an attempt to quantify the degree of risk involved in holding equity shares in a company: risk both in terms of the company's ability to remain in business and in terms of expected ordinary dividends from the company. The problem with a highly geared company is that by definition there is a lot of debt. Debt generally carries a fixed rate of interest (or fixed rate of dividend if in the form of preference shares), hence there is a given (and large) amount to be paid out from profits to holders of debt before arriving at a residue available for distribution to the holders of equity. The riskiness will perhaps become clearer with the aid of an example.

	<i>Company A</i> Rs'000	<i>Company B</i> Rs'000	<i>Company C</i> Rs'000
Ordinary shares	600	400	300
Retained earnings	200	200	200
Revaluation surplus	<u>100</u>	<u>100</u>	<u>100</u>
	900	700	600
6% preference shares (redeemable)	–	–	100
10% loan stock	<u>100</u>	<u>300</u>	<u>300</u>
Capital employed	<u>1,000</u>	<u>1,000</u>	<u>1,000</u>
Gearing ratio	10%	30%	40%
Equity to assets ratio	90%	70%	60%

Now suppose that each company makes a profit before interest and tax of Rs. 50,000, and the rate of tax on company profits is 30%. Amounts available for distribution to equity shareholders will be as follows.

	<i>Company A</i> Rs'000	<i>Company B</i> Rs'000	<i>Company C</i> Rs'000
Profit before interest and tax	50	50	50
Interest/preference dividend	<u>10</u>	<u>30</u>	<u>36</u>
Taxable profit	40	20	14
Taxation at 30%	<u>12</u>	<u>6</u>	<u>4</u>
Profit for the period	<u>28</u>	<u>14</u>	<u>10</u>

If in the subsequent year profit before interest and tax falls to Rs. 40,000, the amounts available to ordinary shareholders will become as follows.

	<i>Company A</i> Rs'000	<i>Company B</i> Rs'000	<i>Company C</i> Rs'000
Profit before interest and tax	40	40	40
Interest/preference dividend	<u>10</u>	<u>30</u>	<u>36</u>
Taxable profit	30	10	4
Taxation at 30%	<u>9</u>	<u>3</u>	<u>1</u>
Profit for the period	<u>21</u>	<u>7</u>	<u>3</u>

Note the following.

Gearing ratio	10%	30%	40%
Equity to assets ratio	90%	70%	60%
Change in PBIT	-20%	-20%	-20%
Change in profit available for ordinary shareholders	-25%	-50%	-70%

The more highly geared the company, the greater the risk that little (if anything) will be available to distribute by way of dividend to the ordinary shareholders. The example clearly displays this fact in so far as the more highly geared the company, the greater the percentage change in profit available for ordinary shareholders for any given percentage change in profit before interest and tax. The relationship similarly holds when profits increase, and if PBIT had risen by 20% rather than fallen, you would find that once again the largest percentage change in profit available for ordinary shareholders (this means an increase) will be for the highly geared company. This means that there will be greater **volatility** of amounts available for ordinary shareholders, and presumably therefore greater volatility in dividends paid to those shareholders, where a company is highly geared. That is the risk: you may do extremely well or extremely badly without a particularly large movement in the PBIT of the company.

The risk of a company's ability to remain in business was referred to earlier. Gearing or leverage is relevant to this. A highly geared company has a large amount of interest to pay annually (assuming that the debt is external borrowing rather than preference shares). If those borrowings are 'secured' in any way (and loan notes in particular are secured), then the holders of the debt are perfectly entitled to force the company to realise assets to pay their interest if funds are not available from other sources. Clearly, the more highly geared a company, the more likely this is to occur when and if profits fall.



### 2.3.4 Interest cover

The interest cover ratio shows whether a company is earning enough profits before interest and tax to pay its interest costs comfortably, or whether its interest costs are high in relation to the size of its profits, so that a fall in PBIT would then have a significant effect on profits available for ordinary shareholders.



#### FORMULA TO LEARN

$$\text{Interest cover} = \frac{\text{Profit before interest and tax}}{\text{Interest charges}}$$

An interest cover of 2 times or less would be low, and should really exceed 3 times before the company's interest costs are to be considered within acceptable limits.

Returning first to the example of Companies A, B and C, the interest cover was as follows.

	<i>Company A</i>	<i>Company B</i>	<i>Company C</i>
(a) When PBIT was Rs. 50,000 =	$\frac{\text{Rs. 50,000}}{\text{Rs. 10,000}}$	$\frac{\text{Rs. 50,000}}{\text{Rs. 30,000}}$	$\frac{\text{Rs. 50,000}}{\text{Rs. 36,000}}$
	5 times	1.67 times	1.39 times
(b) When PBIT was Rs. 40,000 =	$\frac{\text{Rs. 40,000}}{\text{Rs. 10,000}}$	$\frac{\text{Rs. 40,000}}{\text{Rs. 30,000}}$	$\frac{\text{Rs. 40,000}}{\text{Rs. 36,000}}$
	4 times	1.33 times	1.11 times

Both B and C have a low interest cover, which is a warning to ordinary shareholders that their profits are highly vulnerable, in percentage terms, to even small changes in PBIT.



## QUESTION

## Interest cover

**Calculate** and comment on the interest cover of Pacific Co.

## ANSWER

Interest payments should be taken gross, from the note to the accounts, and not net of interest receipts as shown in the statement of profit or loss.

	20X8	20X7
<u>        </u> PBIT	<u>360,245</u>	<u>247,011</u>
Interest payable	18,115	21,909
	= 20 times	= 11 times

Pacific has more than sufficient interest cover. In view of the company's low gearing, this is not too surprising and so we finally obtain a picture of Pacific as a company that does not seem to have a debt problem, in spite of its high (although declining) debt ratio.

### 2.3.5 Cash flow ratio

The cash flow ratio is the ratio of a company's net cash inflow to its total debts.

- (a) Net cash inflow is the amount of cash that the company has coming into the business from its operations. A suitable figure for net cash inflow can be obtained from the statement of cash flows.
- (b) Total debts are short-term and long-term payables, including provisions. A distinction can be made between debts payable within one year and other debts and provisions.

Obviously, a company needs to be earning enough cash from operations to be able to meet its foreseeable debts and future commitments, and the cash flow ratio, and changes in the cash flow ratio from one year to the next, provide a useful indicator of a company's cash position.

### 2.4 Liquidity ratios

Profitability is of course an important aspect of a company's performance and gearing or leverage is another. Neither, however, addresses directly the key issue of **liquidity**.



**Liquidity** is the amount of cash a company can put its hands on quickly to settle its debts (and possibly to meet other unforeseen demands for cash payments too).

**Liquid funds** consist of:

- (a) Cash
- (b) Short-term investments for which there is a ready market
- (c) Fixed-term deposits with a bank or other financial institution, for example, a six-month high-interest deposit with a bank
- (d) Trade receivables (because they will pay what they owe within a reasonably short period of time)
- (e) Bills of exchange receivable (because like ordinary trade receivables, these represent amounts of cash due to be received within a relatively short period of time)

In summary, **liquid assets are current asset items that will or could soon be converted into cash, and cash itself**. Two common definitions of liquid assets are:

- All current assets without exception
- All current assets with the exception of inventories

A company can obtain liquid assets from sources other than sales of goods and services, such as the issue of shares for cash, a new loan or the sale of non-current assets. But a company cannot rely on these at all times, and in general, obtaining liquid funds depends on making sales revenue and profits. Even so, profits do not always lead to increases in liquidity. This is mainly because funds generated from trading may be immediately invested in non-current assets or paid out as dividends.

The reason why a company needs liquid assets is so that it can meet its debts when they fall due. Payments are continually made for operating expenses and other costs, and so there is a **cash cycle** from trading activities of cash coming in from sales and cash going out for expenses.

### 2.4.1 The cash cycle

To help you to understand liquidity ratios, it is useful to begin with a brief explanation of the cash cycle. The cash cycle describes the flow of cash out of a business and back into it again as a result of normal trading operations.

Cash goes out to pay for supplies, wages and salaries and other expenses, although payments can be delayed by taking some credit. A business might hold inventory for a while and then sell it. Cash will come back into the business from the sales, although customers might delay payment by themselves taking some credit.

The main points about the cash cycle are as follows.

- (a) The timing of cash flows in and out of a business does not coincide with the time when sales and costs of sales occur. Cash flows out can be postponed by taking credit. Cash flows in can be delayed by having receivables.
- (b) The time between making a purchase and making a sale also affects cash flows. If inventories are held for a long time, the delay between the cash payment for inventory and cash receipts from selling it will also be a long one.
- (c) Holding inventories and having receivables can therefore be seen as two reasons why cash receipts are delayed. Another way of saying this is that if a company invests in working capital, its cash position will show a corresponding decrease.
- (d) Similarly, taking credit from creditors can be seen as a reason why cash payments are delayed. The company's liquidity position will worsen when it has to pay the suppliers, unless it can get more cash in from sales and receivables in the meantime.

The liquidity ratios and working capital turnover ratios are used to test a company's liquidity, length of cash cycle, and investment in working capital. The cash cycle is also referred to as the operating cycle.

#### 2.4.2 Liquidity ratios: the current ratio and quick ratio

The 'standard' test of liquidity is the current ratio. It can be obtained from the statement of financial position.



##### FORMULA TO LEARN

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

The idea behind this is that a company should have enough current assets that give a promise of 'cash to come' to meet its future commitments to pay off its current liabilities. Obviously, a ratio in excess of 1 should be expected. Otherwise, there would be the prospect that the company might be unable to pay its debts on time. In practice, a ratio comfortably in excess of 1 should be expected, but what is 'comfortable' varies between different types of businesses.

Companies are not able to convert all their current assets into cash very quickly. In particular, some manufacturing companies might hold large quantities of raw material inventories, which must be used in production to create finished goods inventory. These might be warehoused for a long time, or sold on lengthy credit. In

such businesses, where inventory turnover is slow, most inventories are not very 'liquid' assets, because the cash cycle is so long. For these reasons, we calculate an additional liquidity ratio, known as the quick ratio or acid test ratio.



#### FORMULA TO LEARN

The quick ratio, or acid test ratio, is calculated as follows.

$$\text{Quick ratio} = \frac{\text{Current assets less inventory}}{\text{Current liabilities}}$$

This ratio should ideally be at least 1 for companies with a slow inventory turnover. For companies with a fast inventory turnover, a quick ratio can be comfortably less than 1 without suggesting that the company could be in cash flow trouble.

Both the current ratio and the quick ratio offer an indication of the company's liquidity position, but the absolute figures should not be interpreted too literally. It is often theorised that an acceptable current ratio is 1.5 and an acceptable quick ratio is 0.8, but these should only be used as a guide. Different businesses operate in very different ways. A supermarket group for example might have a current ratio of 0.52 and a quick ratio of 0.17. Supermarkets have low receivables (people do not buy groceries on credit), low cash (good cash management), medium inventories (high inventories but quick turnover, particularly in view of perishability) and very high payables.

Compare this with a manufacturing and retail organisation, with a current ratio of 1.44 and a quick ratio of 1.03. Such businesses operate with liquidity ratios closer to the standard.

What is important is the trend of these ratios. From this, one can easily ascertain whether liquidity is improving or deteriorating. If a supermarket has traded for the last 10 years (very successfully) with current ratios of 0.52 and quick ratios of 0.17, then it should be supposed that the company can continue in business with those levels of liquidity. If in the following year the current ratio were to fall to 0.38 and the quick ratio to 0.09, then further investigation into the liquidity situation would be appropriate. It is the relative position that is far more important than the absolute figures.

Do not forget the other side of the coin. A current ratio and a quick ratio can get bigger than they need to be. A company that has large volumes of inventories and receivables might be over-investing in working capital, and so tying up more funds in the business than it needs to. This would suggest poor management of receivables (credit) or inventories by the company.

## 2.5 Efficiency ratios

### 2.5.1 Accounts receivable collection period

A rough measure of the average length of time it takes for a company's customers to pay what they owe is the **accounts receivable collection period**.



#### FORMULA TO LEARN

The estimated average accounts receivable collection period is calculated as:

$$\frac{\text{Trade receivables}}{\text{Sales}} \times 365 \text{ days}$$

The figure for sales should be taken as the sales revenue figure in the statement of profit or loss. Note that any **cash sales should be excluded if possible** – this ratio only uses credit sales. The trade receivables are not the total figure for receivables in the statement of financial position, which includes prepayments and non-trade receivables. The trade receivables figure will be itemised in an analysis of the receivable total, in a note to the accounts.

The estimate of the accounts receivable collection period is **only approximate**.

- (a) The value of receivables in the statement of financial position might be abnormally high or low compared with the 'normal' level the company usually has.
- (b) Sales revenue in the statement of profit or loss is exclusive of sales taxes, but receivables in the statement of financial position are inclusive of sales tax. We are not strictly comparing like with like.

Sales are usually made on 'normal credit terms' of payment within 30 days. A collection period significantly in excess of this might be representative of poor management of funds of a business. However, some companies must allow generous credit terms to win customers. Exporting companies in particular may have to carry large amounts of receivables, and so their average collection period might be well in excess of 30 days.

The **trend of the collection period over time** is probably the best guide. If the collection period is increasing year on year, this is indicative of a poorly managed credit control function (and potentially therefore a poorly managed company).



### 2.5.2 Example: accounts receivable collection period

Using the same types of company as examples, the collection period for each of the companies was as follows.

<i>Company</i>	<i>Trade receivables</i>	<i>Collection period</i>	<i>Previous year</i>	<i>Collection period</i>
	<i>Sales</i>	<i>(× 365)</i>		<i>(× 365)</i>
Supermarket	$\frac{\text{Rs.5,016K}}{\text{Rs.284,986K}} =$	6.4 days	$\frac{\text{Rs.3,977K}}{\text{Rs.290,668K}} =$	5.0 days
Manufacturer	$\frac{\text{Rs.458.3m}}{\text{Rs.2,059.5m}} =$	81.2 days	$\frac{\text{Rs.272.4m}}{\text{Rs.1,274.2m}} =$	78.0 days
Sugar refiner and seller	$\frac{\text{Rs.304.4m}}{\text{Rs.817.3m}} =$	29.1 days	$\frac{\text{Rs.287.0m}}{\text{Rs.3,366.3m}} =$	31.1 days

The differences in collection period reflect the differences between the types of business. Supermarkets have hardly any trade receivables at all, whereas the manufacturing companies have far more. The collection periods are fairly constant from the previous year for all three companies.

### 2.5.3 Inventory turnover period

Another ratio worth calculating is the inventory turnover period. This is another estimated figure, obtainable from published accounts, which indicates the average number of days that items of inventory are held for. As with the average receivable collection period, however, it is only an approximate estimated figure, but one which should be reliable enough for comparing changes year on year.



#### FORMULA TO LEARN

The inventory turnover period is calculated as:

$$\frac{\text{Inventory}}{\text{Cost of sales}} \times 365 \text{ days}$$

This is another measure of how vigorously a business is trading. A lengthening inventory turnover period from one year to the next indicates:

- (a) A slowdown in trading, or
- (b) A build-up in inventory levels, perhaps suggesting that the investment in inventories is becoming excessive.

Generally the **higher the inventory turnover the better**, ie the lower the turnover period the better, but several aspects of inventory holding policy have to be balanced.

- (a) Lead times
- (b) Seasonal fluctuations in orders

- (c) Alternative uses of warehouse space
- (d) Bulk buying discounts
- (e) Likelihood of inventory perishing or becoming obsolete

Presumably if we add together the inventory turnover period and receivables collection period, this should give us an indication of how soon inventory is converted into cash. Both receivables collection period and inventory turnover period therefore give us a further indication of the company's liquidity.



#### 2.5.4 Example: inventory turnover period

The estimated inventory turnover periods for a supermarket are as follows.

Company	<i>Inventory turnover</i>		<i>Previous year</i>
	$\frac{\text{Inventory}}{\text{Cost of sales}}$	$\text{period} \quad (\text{days} \times 365)$	
Supermarket	$\frac{\text{Rs. 15,554K}}{\text{Rs. 254,571K}} =$	22.3 days	$\frac{\text{Rs. 14,094}}{\text{Rs. 261,368K}} \times 365 = 19.7 \text{ days}$

#### 2.5.5 Accounts payable payment period



##### FORMULA TO LEARN

**Accounts payable payment period** is ideally calculated by the formula:

$$\frac{\text{Trade accounts payable}}{\text{Purchases}} \times 365 \text{ days}$$

It is rare to find purchases disclosed in published accounts and so **cost of sales serves as an approximation**. The payment period often helps to assess a company's liquidity; an increase is often a sign of lack of long-term finance or poor management of current assets, resulting in the use of extended credit from suppliers, increased bank overdraft and so on.





## QUESTION

## Liquidity and working capital

**Calculate** liquidity and working capital ratios from the accounts of TEB (Pvt) Ltd, a business that provides service support such as cleaning and maintenance services. Comment on the results of your calculations.

	20X7 Rs million	20X6 Rs million
Sales revenue	2,176.2	2,344.8
Cost of sales	<u>1,659.0</u>	<u>1,731.5</u>
Gross profit	<u>517.2</u>	<u>613.3</u>
Current assets		
Inventories	42.7	78.0
Receivables (note 1)	378.9	431.4
Short-term deposits and cash	<u>205.2</u>	<u>145.0</u>
	<u>626.8</u>	<u>654.4</u>
Current liabilities		
Loans and overdrafts	32.4	81.1
Tax on profits	67.8	76.7
Accruals	11.7	17.2
Payables (note 2)	<u>487.2</u>	<u>467.2</u>
	<u>599.1</u>	<u>642.2</u>
Net current assets	<u>27.7</u>	<u>12.2</u>
<b>Notes</b>		
1 Trade receivables	<u>295.2</u>	<u>335.5</u>
2 Trade payables	<u>190.8</u>	<u>188.1</u>

## ANSWER

	20X7	20X6
Current ratio	$\frac{626.8}{599.1} = 1.05$	$\frac{654.4}{642.2} = 1.02$
Quick ratio	$\frac{584.1}{599.1} = 0.97$	$\frac{576.4}{642.2} = 0.90$
Accounts receivable collection period	$\frac{295.2}{2,176.2} \times 365 = 49.5 \text{ days}$	$\frac{335.5}{2,344.8} \times 365 = 52.2 \text{ days}$
Inventory turnover period	$\frac{42.7}{1,659.0} \times 365 = 9.4 \text{ days}$	$\frac{78.0}{1,731.5} \times 365 = 16.4 \text{ days}$
Accounts payable payment period	$\frac{190.8}{1,659.0} \times 365 = 42.0 \text{ days}$	$\frac{188.1}{1,731.5} \times 365 = 39.7 \text{ days}$

The company's current ratio is a little lower than average but its quick ratio is better than average and very little less than the current ratio. This suggests that inventory levels are strictly controlled, which is reinforced by the low inventory

turnover period. It would seem that working capital is tightly managed, to avoid the poor liquidity which could be caused by a long receivables collection period and comparatively high payables.



## QUESTION

## Operating cycle

- (a) **Calculate** the operating cycle for Da Silva PLC for 20X2 on the basis of the following information.

	Rs'000
Inventory: raw materials	150,000
work in progress	60,000
finished goods	200,000
Purchases	500,000
Trade accounts receivable	230,000
Trade accounts payable	120,000
Sales	900,000
Cost of goods sold	750,000

**Tutorial note.** You will need to calculate inventory turnover periods (total year-end inventory over cost of goods sold), receivables as daily sales, and payables in relation to purchases, all converted into 'days'.

- (b) **List** the steps that might be taken in order to improve the operating cycle.

## ANSWER

- (a) The operating cycle can be found as follows.

$$\text{Inventory turnover period: } \frac{\text{Total closing inventory} \times 365}{\text{Cost of goods sold}}$$

**Plus**

$$\text{Accounts receivable collection period: } \frac{\text{Closing trade receivables} \times 365}{\text{Sales}}$$

**Less**

$$\text{Accounts payable payment period: } \frac{\text{Closing trade receivables} \times 365}{\text{Purchases}}$$

	20X2
Total closing inventory (Rs'000)	410,000
Cost of goods sold (Rs'000)	750,000
Inventory turnover period	199.5 days
Closing receivables (Rs'000)	230,000
Sales (Rs'000)	900,000
Receivables collection period	93.3 days
Closing payables (Rs'000)	120,000
Purchases (Rs'000)	500,000
Payables payment period	(87.6 days)
Length of operating cycle (199.5 + 93.3 – 87.6)	205.2 days

- (b) The steps that could be taken to reduce the operating cycle include the following.
- (i) Reducing the raw material inventory turnover period.
  - (ii) Reducing the time taken to produce goods. However, the company must ensure that quality is not sacrificed as a result of speeding up the production process.
  - (iii) Increasing the period of credit taken from suppliers. The credit period already seems very long – the company is allowed three months' credit by its suppliers, and probably could not be increased. If the credit period is extended, then the company may lose discounts for prompt payment.
  - (iv) Reducing the finished goods inventory turnover period.
  - (v) Reducing the receivables collection period. The administrative costs of speeding up debt collection and the effect on sales of reducing the credit period allowed must be evaluated. However, the credit period does already seem very long by the standards of most industries. It may be that generous terms have been allowed to secure large contracts and little will be able to be done about this in the short term.

## 2.6 Investor ratios

Investor ratios include:

- (a) Earnings per share
- (b) Dividend per share
- (c) Dividend cover
- (d) P/E ratio
- (e) Dividend yield

The value of an investment in ordinary shares in a company **listed on a stock exchange** is its market value, and so investment ratios must have regard not only to information in the company's published accounts, but also to the current price, and the fourth and fifth ratios involve using the share price.

### 2.6.1 Earnings per share

It is possible to calculate the return on each ordinary share in the year. This is the earnings per share (EPS). Earnings per share is the amount of net profit for the period that is attributable to each ordinary share which is outstanding during all or part of the period (see Chapter 20).

### 2.6.2 Dividend per share and dividend cover

The dividend per share in cents is self-explanatory, and clearly an item of some interest to shareholders.



#### FORMULA TO LEARN

Dividend cover is a ratio of: 
$$\frac{\text{Earnings per share}}{\text{Dividend per (ordinary) share}}$$

It shows the proportion of profit for the year that is available for distribution to shareholders that has been paid (or proposed) and what proportion will be retained in the business to finance future growth. A dividend cover of two times would indicate that the company had paid 50% of its distributable profits as dividends, and retained 50% in the business to help to finance future operations. Retained profits are an important source of funds for most companies, and so the dividend cover can in some cases be quite high.

A significant change in the dividend cover from one year to the next would be worth looking at closely. For example, if a company's dividend cover were to fall sharply between one year and the next, it could be that its profits had fallen, but the directors wished to pay at least the same amount of dividends as in the previous year, so as to keep shareholder expectations satisfied.

### 2.6.3 P/E ratio



The **price/earnings (P/E) ratio** is the ratio of a company's current share price to the earnings per share.

A high P/E ratio indicates strong shareholder confidence in the company and its future, eg in profit growth, and a lower P/E ratio indicates lower confidence.

The P/E ratio of one company can be compared with the P/E ratios of:

- Other companies in the same business sector
- Other companies generally

It is often used in stock exchange reporting where prices are readily available.

### 2.6.4 Dividend yield

Dividend yield is the return a shareholder is currently expecting on the shares of a company.



### FORMULA TO LEARN

$$\text{Dividend yield} = \frac{\text{Dividend on the share for the year}}{\text{Current market value of the share (ex-div)}} \times 100\%$$

- (a) The dividend per share is taken as the dividend for the previous year.
- (b) Ex-div means that the share price does **not** include the right to the most recent dividend.

Shareholders look for both dividend yield and capital growth. Obviously, dividend yield is therefore an important aspect of a share's performance.



### QUESTION

### Dividend yield

In the year to 30 September 20X8, an advertising agency declares an interim ordinary dividend of 7.4c per share and a final ordinary dividend of 8.6c per share.

#### Required

**Calculate** the dividend yield assuming an ex-div share price of 315 cents.

### ANSWER

The total dividend per share is  $(7.4 + 8.6) = 16$  cents

$$\frac{16}{315} \times 100 = 5.1\%$$

## 3 Different stakeholder needs



**Financial analysis should take into account who analysis is being performed for; different stakeholders have different needs.**

The Conceptual Framework identifies the principal users of financial statements as investors (both existing and potential) and lenders. There are, however, several other user groups including employees, management, suppliers, customers, the government and the general public.

When performing financial analysis, the reasons for performing it and the audience for which it is for should be considered.

### 3.1 Users and their needs

The following table summarises different stakeholders and their needs:

<b>Existing investors</b>	To understand that their investment is sound and growing; to ascertain whether profits and cash flows are sufficient to support a dividend.
<b>Potential investors</b>	To understand whether a company would form a good investment and what its future prospects may be.
<b>Banks/other lenders</b>	To understand whether funds will be available to repay borrowing. In the case of a long-term loan, this involves understanding the company's ability to continue trading successfully in the future.
<b>Management</b>	To understand how well the company operates in terms of chasing debts, paying suppliers, holding inventory, minimising costs and so on. Management is also concerned with issues such as the replacement of assets.
<b>Employees</b>	To confirm long-term job stability and prospects for career development or pay rises. In the shorter term, profits may be relevant to bonus payments.
<b>Customers</b>	To understand whether a company is in a position to continue a trading relationship into the future; to gain an understanding of profit levels which may help them to negotiate on price.
<b>Suppliers</b>	Suppliers also want to confirm that a company is in a position to continue a trading relationship. They are also interested in being paid and gaining an understanding of whether a customer is in a position to pay on time.
<b>Government</b>	The government is concerned with the level of profits made by a company, as this impacts on tax revenues. It is also concerned with supporting national trade and ensuring competition.
<b>General public</b>	The general public may be concerned with how a company is run in terms of supporting the community and creating jobs.

Note that most stakeholders are less interested in how a company is run and more in how it performs in terms of profits. For example, how long inventory is held for or how long it takes to pay creditors is relevant to management, but of less interest to other parties.

### 3.2 Exam technique

Where an exam places you in a scenario, always consider what type of analysis and which ratios are relevant to that scenario. Focus on the needs of the stated user and avoid calculating all possible ratios if you do not think that they are relevant.

In addition, you should consider any background information provided and how this impacts on your analysis.

## 4 Limitations of financial analysis



**There are a number of limitations of financial analysis, some of which are related to the limitations of historical cost financial statements.**

Financial analysis often cannot provide answers to questions; however it does help a user of financial statements to focus on areas that require more investigation.

For example, calculation of the inventory turnover period may reveal an increase from 5 days to 15 days. This may be due to a variety of reasons, some positive (eg a business has started selling a new stock line with a longer shelf life) and some negative (eg some items are obsolete). Without further investigation, we are unable to conclude which of these is the case and therefore how well the business is performing.

Other limitations are discussed below.

### 4.1 Accounting policies and practices

There remain some areas of accounting where there is a choice of treatment. Where there is a choice and two companies adopt different policies, their financial statements become less comparable. It may also be the case that one company may change its policy or estimates in a given year. Unless retrospective adjustment is required in accordance with LKAS 8, that company's financial statements lose comparability.

Examples of different accounting policies, estimates and practices include:

- Measurement of investment properties using the cost model or fair value model
- Measurement of PPE using the cost model or revaluation model
- Adoption of different useful lives for assets

- A business policy of acquiring PPE by way of operating lease rather than purchasing it
- The use of invoice discounting/factoring of receivables

## 4.2 Calculation of ratios

Although we have defined ratios in this chapter, in practice there are varying ways in which they may be calculated. For example we have explained that gearing is calculated as debt as a proportion of debt plus shareholders' funds. In some cases, however, gearing is calculated as debt as a proportion of shareholders' funds.

For example, in a business with Rs. 10m debt and Rs. 20m shareholders funds, we would calculate gearing as  $\text{Rs. } 10\text{m} / (\text{Rs. } 10\text{m} + \text{Rs. } 20\text{m}) \times 100\% = 33\%$ . Others might however calculate it as  $\text{Rs. } 10\text{m} / \text{Rs. } 20\text{m} \times 100\% = 50\%$ .

Neither is wrong; however the ratios do mean slightly different things:

- The first calculation shows that debt forms 33% of total funding from both debt sources and shareholders
- The second calculation shows that debt is 50% of the level of the alternative source of funding, being shareholders' funds

Although you should use the ratio formulae provided in this chapter in an exam situation, you should be aware of discrepancies.

This problem is further exacerbated by the fact that one (or more) of the elements of a ratio may be identified differently by different parties. For example, 'debt' in the gearing ratio is interest-bearing debt. Some individuals would include an overdraft in this definition, while others would not.

## 4.3 Historical financial statements

Users of the financial statements are interested in the future performance of a company. Historical financial statements and ratios based on them are of limited use in achieving an understanding of future performance. It is not necessarily the case that past performance will continue.

Certain accounting requirements go some way to addressing the problem. These include:

- SLFRS 5 requirements to show assets held-for-sale separately in the statement of financial position and the results of discontinued activities in the statement of profit or loss



- LKAS 37 requirements to recognise provisions and disclose contingent liabilities
- LKAS 17 requirements to disclose operating lease commitments

#### **4.4 Window dressing**

Window dressing is the practice of manipulating the year-end statement of financial position in order to report favourable amounts. For example, delaying payment of a due amount will result in a higher cash balance (or lower overdraft).

Even where window dressing does not take place, it must be remembered that statement of financial position balances are relevant only at the year-end date; they may have varied significantly throughout the year.

As a result of both of these factors, direct comparison of asset and liability balances and ratios that include either of them do not necessarily provide a true view of the position of the company throughout the year.

#### **4.5 Related party transactions**

Where related party transactions have taken place, the financial statements may be skewed. This makes comparison with another company without equivalent transactions less useful.

#### **4.6 Seasonality**

Some businesses are affected by seasonality, eg those in the tourism sector. This issue is less likely to affect the statement of profit or loss and statement of cash flows, as both relate to a full year. The statement of position amounts at the reporting date, however, may not be indicative of amounts throughout the year. It may therefore be more useful to base ratio calculations on average balances of inventory, receivables and payables if these averages are available. Furthermore, care must be taken not to compare the results of a company affected by seasonality with the results of one not affected by this issue.

**QUESTION****Financial analysis**

The following information has been extracted from the recently published accounts of DG.

**EXTRACTS FROM THE STATEMENTS OF PROFIT OR LOSS TO 30 APRIL**

	20X9 Rs'000	20X8 Rs'000
Sales	11,200	9,750
Cost of sales	8,460	6,825
Net profit before tax	465	320
This is after charging:		
Depreciation	360	280
Loan note interest	80	60
Interest on bank overdraft	15	9
Audit fees	12	10

**STATEMENTS OF FINANCIAL POSITION AS AT 30 APRIL**

	20X9 Rs'000    Rs'000		20X8 Rs'000    Rs'000	
<i>Assets</i>				
Non-current assets		1,850		1,430
Current assets				
Inventory	640		490	
Receivables	1,230		1,080	
Cash	<u>80</u>		<u>120</u>	
		1,950		1,690
<i>Total assets</i>		<u>3,800</u>		<u>3,120</u>
<i>Equity and liabilities</i>				
Equity				
Stated capital	800		800	
Retained earnings	<u>1,310</u>		<u>930</u>	
		2,110		1,730
Non-current liabilities				
10% loan stock		800		600
Current liabilities				
Bank overdraft	110		80	
Payables	750		690	
Taxation	<u>30</u>		<u>20</u>	
		890		790
<i>Total equity and liabilities</i>		<u>3,800</u>		<u>3,120</u>

The following ratios are those calculated for DG, based on its published accounts for the previous year, and also the latest industry average ratios:

	DG 30 April 20X8	Industry average
ROCE (capital employed = equity and debentures)	16.30%	18.50%
Profit/sales	3.90%	4.73%
Asset turnover	4.19	3.91
Current ratio	2.14	1.90
Quick ratio	1.52	1.27
Gross profit margin	30.00%	35.23%
Accounts receivable collection period	40 days	52 days
Accounts payable payment period	37 days	49 days
Inventory turnover (times)	13.90	18.30
Gearing	26.75%	32.71%

### Required

- Calculate** comparable ratios (to two decimal places where appropriate) for DG for the year ended 30 April 20X9. All calculations must be clearly shown.
- Prepare** a report to your board of directors analysing the performance of DG, comparing the results against the previous year and against the industry average.

### ANSWER

	20X8	20X9	Industry average
(a) ROCE	$\frac{320 + 60}{2,330} = 16.30\%$	$\frac{465 + 80}{2,910} = 18.72\%$	18.50%
Profit/sales	$\frac{320 + 60}{9,750} = 3.90\%$	$\frac{465 + 80}{11,200} = 4.87\%$	4.73%
Asset turnover	$\frac{9,750}{2,330} = 4.18x$	$\frac{11,200}{2,330} = 3.85x$	3.91x
Current ratio	$\frac{1,690}{790} = 2.10$	$\frac{1,950}{890} = 2.20x$	1.90
Quick ratio	$\frac{1,080 + 120}{790} = 1.52$	$\frac{1,230 + 80}{890} = 1.47$	1.27
Gross profit margin	$\frac{9,750 - 6,825}{9,750} = 30.00\%$	$\frac{11,200 - 8,460}{11,200} = 24.46\%$	35.23%
Accounts receivable collection period	$\frac{1,080}{9,750} \times 365 = 40 \text{ days}$	$\frac{1,230}{11,200} \times 365 = 40 \text{ days}$	52 days
Accounts payable payment period	$\frac{690}{6,825} \times 365 = 47 \text{ days}$	$\frac{750}{8,460} \times 365 = 32 \text{ days}$	49 days
Inventory turnover (times)	$\frac{6,825}{490} = 13.9x$	$\frac{8,460}{640} = 13.2x$	18.30x
Gearing	$\frac{600}{2,330} = 25.75\%$	$\frac{800}{2,910} = 27.5\%$	32.71%

## (b) (i) REPORT

To: Board of Directors

From: Accountant

Date: xx/xx/xx

Subject: Analysis of performance of DG

This report should be read in conjunction with the appendix attached that shows the relevant ratios (from part (a)).

## Trading and profitability

Return on capital employed has improved considerably between 20X8 and 20X9 and is now higher than the industry average.

Net income as a proportion of sales has also improved noticeably between the years and is also now marginally ahead of the industry average. Gross margin, however, is considerably lower than in the previous year and is only some 70% of the industry average. This suggests either that there has been a change in the cost structure of DG or that there has been a change in the method of cost allocation between the periods. Either way, this is a marked change that requires investigation. The company may be in a period of transition as sales have increased by nearly 15% over the year and it would appear that new non-current assets have been purchased.

Asset turnover has declined between the periods although the 20X9 figure is in line with the industry average. This reduction might indicate that the efficiency with which assets are used has deteriorated or it might indicate that the assets acquired in 20X9 have not yet fully contributed to the business. A longer term trend would clarify the picture.

## (ii) Liquidity and working capital management

The current ratio has improved slightly over the year and is marginally higher than the industry average. It is also in line with what is generally regarded as satisfactory (2:1).

The quick ratio has declined marginally but is still better than the industry average. This suggests that DG has no short term liquidity problems and should have no difficulty in paying its debts as they become due.

Receivables as a proportion of sales is unchanged from 20X8 and are considerably lower than the industry average. Consequently, there is probably little opportunity to reduce this further and there may be pressure in the future from customers to increase the period of credit given. The period of credit taken from suppliers has fallen from

37 days' purchases to 32 days' and is much lower than the industry average; thus, it may be possible to finance any additional receivables by negotiating better credit terms from suppliers.

Inventory turnover has fallen slightly and is much slower than the industry average and this may partly reflect stocking up ahead of a significant increase in sales. Alternatively, there is some danger that the inventory could contain certain obsolete items that may require writing off. The relative increase in the level of inventory has been financed by an increased overdraft which may reduce if the inventory levels can be brought down.

The high levels of inventory, overdraft and receivables compared to that of payables suggests a labour intensive company or one where considerable value is added to bought-in products.

(iii) Gearing

The level of gearing has increased only slightly over the year and is below the industry average. Since the return on capital employed is nearly twice the rate of interest on the loan stock, profitability is likely to be increased by a modest increase in the level of gearing.

Signed: Accountant

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**CHAPTER ROUNDUP**

- ↳ **Financial analysis involves appraising and communicating the position, performance and prospects of a business based on given and prepared statements and ratios.**
- ↳ **Ratios can be grouped into five categories: profitability, solvency, liquidity, efficiency and investor ratios.**
- ↳ **Financial analysis should take into account for whom analysis is being performed; different stakeholders have different needs.**
- ↳ **There are a number of limitations of financial analysis, some of which are related to the limitations of historical cost financial statements.**


**PROGRESS TEST**

- 1 List the main categories of ratio.
- 2 ROCE is  $\frac{\text{Profit before interest and tax}}{\text{Capital employed}} \times 100\%$  but what does a ROCE of 15% mean?
- 3 Company Q has a net profit margin of 7%. Briefly comment on this.
- 4 The debt ratio is a company's long-term debt divided by its net assets. True or false?
- 5 The cash flow ratio is the ratio of:
  - A Gross cash inflow to total debt
  - B Gross cash inflow to net debt
  - C Net cash inflow to total debt
  - D Net cash inflow to net debt
- 6 List the formulae for:
  - (a) Current ratio
  - (b) Quick ratio
  - (c) Accounts receivable collection period
  - (d) Inventory turnover period
- 7 A company's gross profit margin has increased in the last year. Which of the following might explain this?
  - A A reduction in directors' salaries
  - B Repayment of an interest-bearing loan at the start of the year
  - C A change in product mix
  - D An increase in the number of units sold
- 8 A company's ROCE falls from 15% to 9%. Which of the following is a valid explanation for this movement?
  - A Profit before interest and tax margin has increased
  - B A large dividend has been paid
  - C There has been a bonus issue of shares
  - D A revaluation surplus has been recognised
- 9 A company has stock of Rs. 300,000, receivables of Rs. 450,000, an overdraft of Rs. 120,000, payables of Rs. 400,000 and a 10-year loan balance of Rs. 600,000. What is the quick ratio?
  - A 1.44
  - B 1.43
  - C 0.87
  - D 0.67

## ANSWERS TO PROGRESS TEST

- 1
  - Profitability and return
  - Long-term solvency
  - Short-term liquidity
  - Efficiency (turnover ratios)
  - Shareholders' investment ratios
- 2 ROCE shows how well the capital employed in a business is used by management to generate profits. Therefore, a ROCE of 15% means that for every Rs. 100 of capital employed, Rs. 15 profit is generated.
- 3 This means that for every Rs. 100 of revenue, the company makes Rs. 7 net profit. You should be careful here. You have very little information. This is a low margin but you need to know what industry the company operates in. 7% may be good for a major retailer.
- 4 False
- 5 The answer is **C**.
- 6
  - (a) Current assets/current liabilities
  - (b) (Current assets – stock)/current liabilities
  - (c) Trade receivables/sales × 365 days
  - (d) Inventory/cost of sales × 365 days
- 7 The answer is **C**. A change in product mix (in favour of higher margin items) is the only possible reason. A and B are both irrelevant, as they are costs below the gross profit line; D is irrelevant, as margins are not affected by volume of sales unless there is a resulting change to selling price or cost of sales.
- 8 The answer is **D**. An increase in the profit before interest and tax margin is likely to result in an increase in ROCE (unless asset turnover falls to compensate for the increase).  
  
 Payment of a dividend reduces capital employed but does not affect profits and therefore would result in an increased ROCE.  
  
 A bonus issue of shares has no impact on ROCE, as capital employed is unchanged and profit before interest and tax is also unchanged.  
  
 An upwards revaluation increases capital employed without any change to profits and so results in a fall in ROCE.
- 9 The answer is **C**. The quick ratio is current assets – stock/current liabilities.  
  
 Therefore,  $450/520 = 0.87$ .



# Index



**A**

Accountancy profession, 23  
 Accounting estimates, 92  
**Accounting policies, 88, 90**  
 Accounting standards, 18  
 Accounts payable payment period, 654  
 Accounts receivable collection period, 652  
 Accrual basis, 78  
 Accrued expenses, 308  
 Accrued income, 308  
 Accumulated depreciation, 317  
 Acid test ratio, 651  
**Acquiree, 493**  
**Acquirer, 493**  
 Acquisition journal, 511  
**Active market, 158**  
 Actuarial gains and losses, 383  
 Actuarial method, 200  
 Adjusting events, 273  
 Aggregation, 78  
**Agricultural activity, 245**  
**Agriculture produce, 245**  
 Amortisation, 157  
 Amortised cost, 345  
**Asset, 42**  
 Asset turnover, 640  
 Assets held for sale, 417, 418  
**Associate, 488, 567, 568**  
 Available-for-sale, 342

**B**

Basic earnings per share, 463  
 Big GAAP/little GAAP, 618  
 Big GAAP/little GAAP divide, 618  
 Bill and Hold sales, 289  
**Biological asset, 245**  
 Borrowing costs, 115

**C**

**Capital, 638**  
 Capital gearing ratio, 644  
 Capital maintenance, 49  
**Carrying amount, 112, 135**

**Cash, 596**

Cash and cash equivalents, 596  
 Cash cycle, 649

**Cash equivalents, 596**

Cash flow information  
     benefits, 595

Cash flow ratio, 648

**Cash flows, 596**

Cash-generating units, 181

Cash-settled share-based payments, 404

**Change in accounting estimate, 88****Close members of the family of an individual, 436****Closing rate, 95**

Companies legislation, 7

**Comparability, 40**

Comparative information, 79

Complex assets, 113, 121

Compound financial instruments, 335

Conceptual framework, 33

Conceptual Framework for Financial Reporting, 35

Consignment sales, 290

Consistency, 79

**Consolidated financial statements, 491**

Consolidated statement of financial position, 507

Consolidated statement of profit or loss, 537

Consolidation schedule, 510, 540

Constraints on useful information, 42

**Contingent asset, 271****Contingent consideration, 494****Contingent liability, 270**

Contingently issuable shares, 476

Contract costs, 227

Contract revenue, 226

**Control, 436, 489**

Convertible instruments, 474

Corporate governance, 13

**Cost, 112, 115, 118, 135**

Cost model, 140, 156

**Costs to sell, 422****Current asset, 82**

**Current cost, 48**  
**Current liability, 82**  
 Current ratio, 650  
 Current tax, 301  
 Current/non-current distinction, 82

## D

Debt ratio, 643  
 Debt/equity ratio, 645  
 Deductible temporary differences, 305, 315  
 Deferred tax, 304  
 Deferred tax asset, 304, 316, 319  
 Deferred tax liability, 304, 310, 319  
**Defined benefit plans, 374, 376**  
**Defined contribution plans, 374, 375**  
 Depreciation, 118, 312  
 Depreciation method, 120  
 Derivatives, 353  
**Development, 160**  
 Development costs, 312  
 Differential reporting, 619  
 Diluted earnings per share, 470  
 Direct method, 601  
**Discontinued operation, 417, 425**  
 Discounting, 262  
 Dismantling and removal costs, 115  
**Disposal group, 420**  
 Disposal of a subsidiary, 555  
 Dividend cover, 658  
 Dividend per share, 658  
 Dividend per share and dividend cover, 658  
 Dividend yield, 658  
 Dividends, 284, 287  
 Downstream transactions, 573, 586  
 Due process, 20

## E

Earning per share, 461, 657  
 Effective interest method, 345  
 Efficiency ratios, 652  
 Elements of financial statements, 42  
 Embedded derivatives, 355  
 Employee Benefits, 367

**Equity, 43, 335**  
**Equity instrument, 334**  
**Equity method, 568**  
 Equity-settled share-based payments, 398  
 Errors, 93  
**Events after the reporting period, 272**  
**Exchange difference, 95, 98**  
 Exchanges of assets, 155  
 Exclusion of a subsidiary from consolidation, 491  
 Exemption from preparing group accounts, 491  
 Expected value approach, 261  
**Expenses, 45**

## F

Fair presentation, 77  
**Fair value, 50, 112, 118, 135, 240, 422, 494**  
 Fair value adjustments, 519  
 Fair value less costs of disposal, 177  
**Fair value model, 140**  
 Fair value through profit or loss, 342  
**Faithful representation, 40**  
**Finance lease, 194, 199, 205**  
**Financial asset, 334, 342**  
**Financial instrument, 331, 333, 344**  
**Financial liability, 334, 335, 350**  
 Financial Statement Analysis, 631  
**Financing activities, 596, 598**  
**Foreign currency, 95**  
 Foreign Currency Transactions, 94  
**Forgivable loans, 240**  
 Framework, 283  
 Framework for the preparation and presentation of Financial Statements, 5  
**Functional currency, 95**  
**Future economic benefit, 43**

## G

GAAP, 6  
 Gain on a bargain purchase, 515

General purpose financial reporting, 38  
 Global Reporting Initiative, 63  
**Going concern, 39, 78**  
**Goodwill, 494, 511**  
 Goodwill impairment, 515  
**Government, 239**  
**Government assistance, 239**  
**Government grant, 156, 239**  
**Grants related to assets, 240**  
**Grants related to income, 240**  
 Gross profit margin, 642  
 Group accounts, 487

## H

Held-to-maturity, 342  
**Historical cost, 48**  
 Horizontal analysis, 632

## I

IAS 1 *Presentation of financial statements*, 610  
 IAS 11 *Construction contracts*, 226  
 IAS 38 *Intangible assets*, 152  
 IAS 40 *Fair value model*, 135  
**Identifiable, 153, 494**  
 IFRIC 1 *Changes in existing decommissioning, restoring and*, 269  
 IFRIC 4 *Determining whether an arrangement contains a lease*, 208  
 IFRIC 5 *Rights to interests arising from decommissioning, restoration and environmental rehabilitation funds*, 269  
 IFRIC 6 *Liabilities arising from participating in a specific market – waste electrical and electronic equipment*, 268  
 IFRIC 12 *Service Concession Arrangements*, 291  
 IFRIC 13 *Customer loyalty programmes*, 292  
 IFRIC 14 IAS 19 – *The limit on a defined benefit asset, minimum*

*funding requirements and their interaction*, 380  
 IFRIC 15 *Agreements for the construction of real estate*, 292  
 IFRIC 17 *Distributions of Non-Cash Assets to Owners*, 87  
 IFRIC 18 *Transfers of Assets from Customers*, 293  
 IFRS Foundation, 17  
 Impairment, 171  
 Impairment of goodwill, 544  
 Impairment test, 176  
**Impracticable, 89**  
**Income, 45**  
 Income Taxes, 299  
 Indications of impairment, 174  
 Indirect method (cash flows), 601  
**Intangible asset, 151, 153**  
 Integrated reporting, 66  
 Integrated reporting framework, 66  
**Interest, 284, 287**  
 Interest cover, 647  
 Interest revenue, 311  
 Interim financial reports, 100  
 Interim financial statements, 100  
 Interpretations, 22  
 Intra-group trading, 546  
 Intra-group transactions, 523  
 Inventory turnover period, 653  
**Investing activities, 596, 598**  
**Investment property, 133, 135**  
 Investor ratios, 657

## J

**Joint arrangement, 580**  
**Joint control, 436, 580**  
**Joint operation, 580**  
**Joint venture, 580, 585**

## K

**Key management personnel, 436**

## L

Leases, 193  
**Leverage, 644**

**Liability, 43, 258**

Limitations of financial analysis, 661

**Liquidity, 648**

Liquidity ratios, 648

LKAS 1 *Presentation of financial statements*, 76

LKAS 2 *Inventories*, 218

LKAS 7 *Statements of cash flows*, 594

LKAS 8 *Accounting policies, changes in accounting estimates and errors*, 88

LKAS 11 *Construction contracts*, 225

LKAS 12 *Income Taxes*, 300

LKAS 16 *Property, plant and equipment*, 112

LKAS 18 *Revenue*, 283

LKAS 19 *Employee benefits*, 369

LKAS 20 *Government grants*, 239

LKAS 21 *The effects of changes in foreign exchange rates*, 95

LKAS 23 *Borrowing costs*, 115

LKAS 24, 434

LKAS 27 *Separate financial statements*, 490

LKAS 28 *Investments in associates and joint ventures*, 567

LKAS 33 *Earnings per share*, 462

LKAS 36 *Impairment of assets*, 173

LKAS 37, 258

LKAS 39 *Financial instruments: recognition and measurement*, 339

LKAS 41 *Agriculture*, 245

Loan, 312

Loan payable, 308

Loans and receivables, 342

**M**

**Material, 78, 88, 219**

**Materiality, 39, 78**

Measurement of the elements of financial statements, 47

Mid-year acquisitions, 541

**Monetary items, 95**

**N**

Net profit margin, 642

**Net realisable value (NRV), 219, 317**

Non-adjusting events, 274

**Non-controlling interest, 494, 512, 517, 542**

Non-financial reporting, 61

**O**

**Obligation, 44**

**Operating activities, 596, 597**

**Operating lease, 135, 195, 197, 204**

Operating segment, 447, 449

Other comprehensive income, 85, 550

Other long-term benefits, 390

**Other long-term employee benefits, 370**

**Owner-occupied property, 135**

**P**

P/E ratio, 658

PBIT, profit before interest and tax, 637

**Post-employment benefits, 370**

Potential ordinary shares, 471

Prepaid expenses, 312

Present obligation, 259

**Present value, 48**

**Presentation currency, 95**

Presentation of Financial Statements, 73

**Price/Earnings (P/E) ratio, 658**

Primary profitability ratio, 640

**Prior period errors, 88**

Profit attributable to ordinary shareholders, 464

Profit margin, 640

Profitability ratios, 637

**Property, plant and equipment, 109, 112**

**Prospective application, 89**

**Provision, 257, 258**

## Q

Qualitative characteristics, 39  
Quick ratio, 650, 651

## R

Ratio analysis, 634  
**Realisable value, 48**  
Recognition, 46  
Redeemable preference shares, 335  
Reimbursements, 263  
**Related party, 435**  
**Related party transaction, 433, 436**  
**Relevance, 39**  
Remeasurements, 383  
Reportable segments, 450  
**Research, 160**  
Research and development (R&D)  
    costs, 317  
Residual Value, 119  
Restructuring, 265  
Retirement benefit costs, 316  
**Retrospective application, 88**  
**Retrospective restatement, 88**  
Return on equity, 639  
Revaluation, 122  
Revaluation model, 156  
Revenue, 281, 284  
Rights issue, 467  
**ROCE, 638**  
**ROE, 639**  
**Royalties, 284, 287**

## S

Sale and repurchase, 290  
Sale of goods revenue, 312  
Sale or return, 290  
SEC regulations, 8  
Segment reporting, 448  
**Settlement value, 48**  
Share options, 473  
Share-based Payments, 395  
**Short-term employee benefits, 370, 371**  
SIC 31 *Revenue – barter transactions involving advertising services*, 294

SIC 32 *Intangible assets – website costs*, 165  
SIC-15 *Operating leases – incentives*, 207  
**Significant influence, 436, 568**  
SLFRS 2, 397  
SLFRS 3 *Business combinations*, 493  
SLFRS 5, 418  
SLFRS 7 *Financial Instruments: Disclosures*, 356  
SLFRS 8 *Operating segments*, 448  
SLFRS 9 *Financial instruments*, 341, 348, 353  
SLFRS 10, 509  
SLFRS 10 *Consolidated financial statements*, 491  
SLFRS 11 *Joint arrangements*, 580  
SLFRS 12 *Disclosure of interests in other entities*, 587  
SLFRS 13 *Fair value measurement*, 50  
  
SLFRS for SMEs, 618, 620  
Small and medium-sized entities, 621  
Solvency ratios, 642  
Specified Business Entities, 621  
**Spot exchange rate, 95**  
Statement of Cash Flows, 593  
Statement of changes in equity and notes, 86  
Statement of financial position, 80  
Statement of profit or loss and other comprehensive income, 83  
Substance over form, 40  
Sustainability reporting, 63

## T

Tax base, 305, 306  
Tax payments, 310  
Tax planning opportunities, 322  
Taxable temporary differences, 305, 310  
Temporary tax differences, 316  
**Termination benefits, 370**  
The Conceptual Framework, 31  
The current ratio, 650  
**Timeliness, 41**

Timing differences, 314

Trend analysis, 632

## **U**

**Understandability, 41**

Unrealised profits, 524, 547

Upstream transactions, 573, 586

Useful life, 119

Users of accounting information, 37

Users of financial accounts, 659

Users of the financial statements, 5

## **V**

Value in use, 177

**Verifiability, 41**

Vertical trend analysis, 632

Vesting conditions, 403

## **W**

Weighted average number of  
ordinary shares, 465